The Political Economy of Hedge Fund Regulation

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ABBREVIATIONS

AHE	Association for Heterodox Economics
AMEX	American Stock Exchange
BIS	Bank for International Settlements
CBOE	Chicago Board Options Exchange
CFD	Contract for Difference
CFMA	Commodity Futures Modernization Act
CFTC	Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System
CPO	Commodity Pool Operator
CRMPG	Counterparty Risk Management Policy Group
CSFB	Credit Suisse First Boston
CSFI	Centre for the Study of Financial Innovation
CTA	Commodity Trading Adviser
EMH	Efficient Market Hypothesis
ERM	Exchange Rate Mechanism
FCM	Futures Commission Merchant
FED	Federal Reserve Bank
FRM	Financial Risk Management
FSA	Financial Services Authority
FSF	Financial Stability Forum
G-7	Group of Seven
GFA	Global Financial Architecture
GPG	Global Public Good
HFA	Hedge Fund Association
HFR	Hedge Fund Research
HLI	Highly Leveraged Institution
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IPE	International Political Economy
IPO	Initial Public Offering
IR	International Relations
ISDA	International Swaps and Derivatives Association
LIFFE	London International Financial Futures and Options Exchange
LTCM	Long-Term Capital Management
MAR	Managed Account Reports
MPT	Modern Portfolio Theory
MWGED	Multidisciplinary Working Group on Enhanced Disclosure
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation System
NFA	National Futures Association
NGO	Non-Governamental Organisations
NYSE	New York Stock Exchange
OCC	Office of the Controller of the Currency
OTC	Over-The-Counter (derivatives)
OTCBB	OTC Bulletin Board
PAE	Post-Autistic Economics

PFE	Potential Future Exposures
PTD	Proprietary Trading Desk
PWG	(US) President's Working Group on Financial Markets
REIT	Real Estate Investment Trust
RIC	Regulated Investment Company
SEC	Securities and Exchange Commission
SRO	Self-regulatory Organisation
SSF	Single-Stock Futures
UK	United Kingdom
UNDP	United Nations Development Programme
US	United States
VAR	Value-At-Risk
VHA	Van Hedge Adviser
WEI	World Equity Index

Currencies

$ United States of America Dollar
€ European Currency (Euro)

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DECLARATION

This dissertation is my own work, and it has not been submitted for a degree at another university.

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ABSTRACT

The currency crises and episodes of market unrest of the 1990s sparked a series of regulatory initiatives to reform the Global Financial Architecture. One of these initiatives tackled the activities of hedge funds, a type of investment vehicle that was frequently cited as one of the causes of these crises. The key research question of this thesis is why efforts to regulate an apparently destabilising aspect of financial markets failed, despite the setting up of an *ad hoc* forum at the international level (the Financial Stability Forum) and various domestic initiatives in the US, the country where most hedge funds operate.

The thesis develops a theoretical framework that examines this regulatory inaction through three explanatory models. The first model draws upon mainstream economic accounts and argues that the empirical evidence did not justify more interventionist public regulation of hedge funds. The second model assumes that a form of relational power has been exercised at the regulatory table: those actors with an interest in leaving hedge funds unregulated prevailed over those that favoured a more mandatory approach. The third model argues that it was not just relational power that determined outcomes, but mainly the power of the structure of meaning within which discussions took place and problems were framed. This structure of meaning led to a particular formulation of the problem at stake, which excluded other concerns and actors from the regulatory agenda.

Each model is analysed for its policy implications. The first model leads to regulatory solutions that rely upon private actors' due diligence and self-assessment of risk. The second model leads to policy options that favour a greater inclusion of developing countries and other stakeholder groups in decision-making processes in global finance. The third model leads to a rethinking of the very tenets of financial market regulation and of the financial theories used to explain and govern the market. The thesis argues that the third model is better able to grasp the complexity of power beyond the seemingly technical nature of financial regulation. For this reason, it is deemed more suitable to provide policy solutions that challenge the current neo-liberal framework of regulation.

INTRODUCTION

This thesis explains why the financial crises and episodes of market unrest of the 1990s have not prompted more interventionist public regulation on hedge funds. To set the scene for this analysis, this introduction first explains the role of hedge funds against the background of recent market crises and in the context of current understandings of financial speculation. It then goes on to elaborate the research question and the general argument of the thesis (first and second sections). In the third and fourth sections it sets out the theoretical framework and the major methodological concerns of the thesis. In the fifth section it reviews the contributions of the study to the field of IPE and in the sixth section it presents the chapter structure.

The research problem

'Never before has the subject of speculation attracted as much attention as it does today' (Chancellor 1999: ix). Although financial speculation has been an aspect of market behaviour for a long time (Bernstein 1996; Chancellor 1999; Mackay 1852; Kindleberger 1978; Bagehot 1872; De Goede 2001; De Goede 2000), it is only in the 20th century that it came to be perceived as a political and regulatory concern that ought to be addressed in a concerted manner at the international level. This first happened after World War II with the negotiations that led to the Bretton Woods system and, more recently, with the regulatory initiatives sparked by the Asian financial crises of 1997 and the emerging market turmoil of 1998. These initiatives have been seen as an effort to reform the current 'global financial architecture' and to adapt it to an environment where speculation plays an unprecedented role. For this reason it can be said that

the international political economy of speculation has come of age after the events of 1997/1998.

There are multiple definitions of financial speculation. Two concepts of speculation in particular coexist in contemporary debates. The first and dominant one is put forward by mainstream finance and maintains that speculation is an essential part of the mechanism of the market and indeed plays a crucial role in bringing efficiency and stability to the market (Bachelier 1900; Fama 1970; Friedman 1953). The second one comes from Keynes's distinction between enterprise or investment on the one hand and speculation on the other: while the former is said to look at the 'prospective yield of assets over their whole life' (Keynes 1936: 158) and hence at an investment in the productive capacity of an economy or a company, the latter is said to profit from fluctuations in asset prices that are governed by investors' 'animal spirits'. As a result, Keynes defines speculation as 'the activity of forecasting the psychology of the market' (Keynes 1936: 158). The contemporary usage of the term embodies this tension between speculation as rational and auxiliary to the real economy and speculation as something that profits from investors' irrationality. What is often overlooked within this debate is the *politics* of financial speculation. Speculation, in fact, is produced and reproduced through regulatory decisions and non-decisions. On this view, market practices are to be seen as expressions of strategies of power between competing interests, rather than a matter of rational versus irrational behaviour.

This thesis deals with the politics of financial speculation by focusing on the regulatory debate concerning hedge funds. Hedge funds have been described as the late twentieth century incarnation of the speculator and have somehow contributed to define the meaning of the term at the turn of the century. Since the Asian financial crisis of 1997 and to a larger extent with the near-collapse of Long-Term Capital Management in 1998, hedge funds have been among the

most cited (and blamed) market actors in discussions of financial crises. Concerns have focused on their ability to manipulate currency and equity markets and to be the source of systemic risk should a highly leveraged hedge fund collapse (for technical terms such as leverage see Glossary, page 303).

This has been confirmed by the place they have increasingly occupied in the literature on financial crises and speculation. Paul Krugman devoted an entire chapter of *The Return of Depression Economics* to describe how hedge funds 'have rocked world markets' and played a fundamental role in the latest financial and currency crises (Krugman 1999: 119). Edward Chancellor, author of the acclaimed *Devil Take the Hindmost*, a history of financial speculation, defined them as 'the most purely speculative investment vehicles of the late twentieth century' (Chancellor 1999: 335). David Marsh in his analysis of Marxism goes even further and takes hedge funds as a key example of the contradiction within contemporary capitalism (Marsh 2002: 165); and all this without taking into account the considerable literature that has grown up around the collapse of LTCM (Dunbar 2000; Temple 2001; Lowenstein 2001). This literature has presented an image of hedge funds as investment vehicles pursuing aggressive trading strategies and run by smart individuals, who are able to outperform any other investment class and to achieve superior returns. Their effect on the market, and on the economy, is also portrayed as exceptional: if they fail, the high leverage they are able to accumulate, and the concentration of their positions, makes for an even larger impact than other market actors.

Technically, hedge funds are defined as private investment partnerships that operate largely outside any regulatory net and, as a consequence, have maximum flexibility in their investment strategies. They are especially known for the use of two kinds of strategies: the first consists in taking directional bets on the likelihood of changes in macroeconomic indicators such as currency or interest rates; and the second in trying to profit from perceived mispricing among

similar assets and in general from inefficiencies in price formation. Hedge funds using the first type of strategy are known as macro funds or currency speculators and were active in Asia during 1997 as well as in other currency crises throughout the 1990s. Hedge funds using the second type of strategy are known as arbitrage or market neutral funds. An excellent example is LTCM, the US-based hedge fund that almost collapsed in the wake of the emerging market turmoil of 1998 (De Goede 2001).

Hedge funds have been targeted not only because they carry out speculative activities, but because they are unregulated or loosely regulated when they do so. The question of whether their regulation could help avoid the recurrence of financial crises thus became a cornerstone in discussions on the Global Financial Architecture (GFA). The regulatory debate on hedge funds can be seen as one of a series of proposals to reform the GFA.

Hedge funds came under close scrutiny in 1998/1999 in the US, the country from which most of them are managed. In February 1999, G7 Finance Ministers and Central Bank Governors meeting in Bonn endorsed the creation of the Financial Stability Forum (FSF) and entrusted it to carry out research on, among other issues, the role and impact of hedge funds in financial markets. The *FSF Working Group on Highly Leveraged Institutions* was created along with a specific task force to address the role of hedge funds in the emerging market crises of 1997/1998, the *Study Group on Market Dynamics*. The name reveals that *highly leveraged institutions* (HLIs) rather than hedge funds were meant to be the focus of the Working Group: the change of name was made to reflect the fact that other investors could engage in similar activities and achieve levels of leverage similar to those of hedge funds. The change of name will be further discussed in Chapters 2 and 4. For now, it can be said that it did not fundamentally change the focus of the debate. For this reason, this dissertation generally sticks to the name hedge fund. Another important remark is that, although other countries and

international institutions have held some discussions on the regulation of hedge funds, this thesis considers that the debates in Washington and Basel have been the most significant: hence the focus will be on the work of the FSF and US regulators.

The debates in Basel and Washington saw the creation of many initiatives and were, according to those directly involved, intense and challenging. Yet by 2002, when both regulators in Basel and Washington considered the debate on hedge funds closed, hedge funds had been left essentially untouched. Why?

The key research question of this thesis is why efforts to regulate an apparently destabilising force of financial markets came to nothing, despite the setting-up of an ad-hoc forum (FSF) and various initiatives at both the domestic and international levels. If one compares the situation before and after the debate took place, as do Chapters 4 and 5, one finds only minor differences and no protective mechanism has been put into place should a new financial crisis like the one that hit Asia break out or should a new crisis of liquidity provoke the collapse of another LTCM. In other words, the whole debate on hedge funds can be seen as a series of *regulatory failures*.

Hedge funds have been left unregulated in several ways. To begin with, very few measures directly targeted at hedge funds were recommended at the regulatory table. Second, even fewer of these recommendations were implemented. Third, the approach that regulators used towards hedge funds was a non-mandatory one, which relied upon investors' due diligence and self-restraint to bring recommendations into effect. (Due diligence is defined as the proper care and attention investors need to exercise in their business.) Finally, many issues related to the operation of hedge funds remained marginal and did not make it to the policy agenda. Why was this so?

Argument of the thesis

The argument of the thesis is that these regulatory failures are the combined result of a decision-making setting that favours the interests of certain actors (specifically the US administration and the transnational financial community) and of a structure of meaning that promotes self-regulation and due diligence as opposed to mandatory approaches to regulation.

On the one hand, hedge funds have been left untouched because the US government – and specifically the US regulatory complex made up of the Treasury, the Federal Reserve, the Securities and Exchange Commission (CFTC) and the Commodity Futures Trading Commission (CFTC) – had no interest in fostering more comprehensive and effective regulatory arrangements at both the domestic and the international levels. This occurred for two main reasons:

- the financial community, which opposed any regulation of hedge funds, has a great influence on the US domestic regulatory process;
- the US government does not support strong institutional settings at the international level and prefers a system where it can set the rules of the game.

On the other hand, regulatory discussions took place within a particular structure of meaning (Cox 1996: 517-518) or discursive apparatus (Foucault 1980: 196-197), which greatly constrained the range of choices that could be made. This regulatory structure of meaning increasingly revolves around due diligence and self-assessment of risk and away from more public and mandatory approaches to regulation. Chapter 5 analyses the main tenets of this regulatory discourse and how they combine with the economic theorisation of hedge funds to make the case for their non-regulation. In addition to an analysis that is solely based on the

interests of participating actors, a study of the meaning assigned to regulatory proposals, institutions and the very principles that guide action allows for a more thorough understanding of power in financial markets and for policy options that challenge the current neo-liberal framework of regulation.

To conclude, both the interests of the dominant actors in the debate (US regulatory complex and transnational financial community) *and* the regulatory structure of meaning within which discussions took place and problems were framed conspired to leave hedge funds unregulated. Both explanations will be considered in defining a political economy approach to the regulation of hedge funds, which stands in opposition to the economic approach of Business Schools and Finance departments. The explanation based on the structure of meaning, however, will be privileged, as it is able to provide a more exhaustive analysis of power in seemingly technical debates such as those concerning the regulation of financial markets. The thesis will explore this perspective through Foucault's concept of apparatus and post-structuralist analyses of power in decision-making processes (see for instance Shapiro 1981 and 1992).

Theoretical framework

This thesis develops a theoretical framework that explains the outcome of the regulatory debate on hedge funds by means of three explanatory models. Each explanatory model promotes a particular interest and results in a different set of policy options. The first is the model provided by mainstream approaches in finance and economics, while the second and the third represent a more heterodox political economy approach. Although this thesis provides an outline of all three models, it makes a case for the third, as this section is now going to elucidate.

The *first explanatory model* says that hedge funds have been left untouched because the empirical evidence did not point to the need for a more mandatory approach. Economists and regulators investigated the issue and reached the conclusion that the extent to which hedge funds represent a threat to the market does not justify tighter public regulation. On the contrary, economists and regulators repeatedly stressed the role of hedge funds in promoting market efficiency. This explanation was the dominant one in regulatory circles such as the International Monetary Fund (IMF), the FSF and domestic agencies in Washington (Securities and Exchange Commission and Commodity Futures Trading Commission). This explanation is said to draw on facts and numbers about hedge funds and therefore to provide a neutral and scientific account. Chapters 2 and 3, however, show that facts and numbers are value-loaded and should be questioned in terms of the interests they promote. Behind the call for efficiency, mainstream finance explanations defend a self-regulating market and the *status quo* in financial markets in general.

The second and third explanatory models represent the political economy approach that this thesis brings forward. They draw upon Steven Lukes's three views of power (Lukes 1974; see also Lukes 1977 and 1986) and show how they can be re-interpreted through the International Political Economy literature. The second explanatory model draws upon Lukes's one- and two-dimensional views of power, while the third explanatory model draws upon Lukes's three-dimensional view.

The *second explanatory model* focuses on the group of states (and more precisely state regulatory agencies) that met at the FSF in Basel to carry out discussions over the regulation of hedge funds. Following Lukes's definition of the one-dimensional view of power, the focus is on the decision-making process at the FSF, which evidenced a conflict among competing interests (especially between developed countries and emerging markets) and where one set of

recommendations prevailed over the others. In the IPE literature, the realist and neo-realist perspectives best capture this concept. From these perspectives, the debate at the FSF would be analysed in terms of inter-state relations: each state tries to maximise its own interests and the outcome of the debate is a consequence of the direct power of participating states, with the interests of the dominant one (the US) prevailing. Contrary to the argument of the end of US hegemony in financial affairs (Gilpin 1987; Krasner 1983), the empirical evidence collected on the FSF discussions supports the thesis that the US government is still the dominant player (Strange 1987 and 1988; Gill 1988; 1990).

Even though this view finds support among several FSF members (e.g. Australia, Hong Kong), it is not totally convincing for several reasons. To start with, it considers the FSF debate to involve only states, while those participating include private as well as public actors. Second, each state cannot be analysed monolithically as the expression of a common unified national interest. The domestic debate in the US indeed reveals that the formation of the 'US interest' with regard to hedge funds occurred through one group (financial community) prevailing over others. The domestic aggregation of interests and the links between these domestic interests and international (or transnational) forces is not accounted for in the realist and neo-realist perspective. Finally, the analysis cannot be limited to the actual decision-making process, that is, to the issues that made it to the regulatory agenda. Other issues remained outside this agenda, either because they were intentionally excluded or because they were not perceived as problems.

By introducing Lukes's two-dimensional view of power, the second explanatory model can account for the role of the institutional setting beyond interstate relations. The two-dimensional view says that 'power is also exercised when A devotes his energy to creating or reinforcing social and political values and *institutional practices* that limit the scope of the political process

to public consideration of only those issues which are comparatively innocuous to A' (Lukes 1974: 237, my italics). The analysis will move to consider those IPE approaches that deal with the role of institutions, mainly regime theories and institutional perspectives. In particular, it will ask whether institutions are able to challenge the dominant powers or are only another way by which dominant actors impose their will: by establishing institutional settings that are beneficial to the interest of the strong, institutions can become a means to keep uncomfortable issues outside the regulatory agenda and to prevent any decision on them (non-decisions).

By considering those issues that did not make it to the regulatory agenda, the two-dimensional view of power overcomes some of the analytical limits of the one-dimensional view – specifically the emphasis on a narrowly defined decision-making process. Yet it still confines the analysis to situations where a conflict is present and where individuals make conscious decisions about alternatives. It forbids an analysis of power in all those situations where a conflict is not present and it is the very formation of grievances and claims giving rise to conflicts that is to be prevented. This is what the third explanatory model deals with.

Drawing upon Lukes's three-dimensional view of power, the *third explanatory model* says that deliberate conflicts to keep grievances outside the policy agenda might be unnecessary if grievances are prevented from being formulated and perceived as such in the first place. This model builds upon Lukes's three-dimensional view and adds to it a post-structuralist perspective. Things get excluded from the political or regulatory agenda not only because some actors *intentionally* oppose them or prevent them from being spoken about, but also because of the structural power of the framework of meaning within which discussions take place. By introducing the concept of *regulation-as-discourse*, this model shows that the structure of meaning within which discussions are carried out and issues framed sets limits to what can be said. In other words, grievances and claims can be formulated only when they have become part

of a discourse. By this means, the third explanatory model introduces and applies Foucault's concept of the 'unsaid' and shows that what is not said or excluded from a discourse is still an essential part of it. The analysis of the unsaid becomes the inevitable corollary of challenging a dominant discourse. It stems from the question: if this is what the debate deals with, what is that which remains unformulated and unquestioned?

Each explanatory model points to a different set of policy options to reform regulatory practices in finance and, in this specific case, the regulatory regime of hedge funds. The first model favours a regulatory approach based on private actors' due diligence and self-regulation. As hedge funds perform a useful role in bringing efficiency to the market, more restrictive measures would compromise their ability to do so. Hence efficiency will be better guarded by leaving market actors sorting things out by themselves. Various recommendations taken in Basel and Washington reflect this view. For instance, the idea of indirectly regulating hedge funds by relying upon their counterparties' due diligence and self-assessment of risk is a clear expression of the trust that regulators accord to private players in bringing about regulatory solutions.

The second explanatory model points to the need for broader participation in financial policy-making. Since the US government and the transnational financial community dominate the agenda and institutions like the FSF are only a means for these interests to prevail, a solution is to bring other countries and other interest groups into the decision-making process. The United Nations Development Program (UNDP), for instance, has promoted this view by calling for emerging market representation in venues such as the Bank for International Settlements (BIS) and the FSF. According to the UNDP, 'adding a small representation of developing countries to [the FSF] would: a) increase its legitimacy, b) increase developing countries' commitments to its aims and c) add valuable insights and perspectives to its decision-making process' (Griffith

Jones 2002: 2). Another UNDP suggestion is to give back to public regulators some of the functions they lost to the financial community, or at least to make private actors more accountable to other sectors of society (Kaul and Schnupf 2001).

While raising an important issue of inclusion, this policy perspective implicitly blesses the FSF aims and principles – to 'increase developing countries' commitments to the FSF aims' – and assumes that a broader participation in it would be beneficial to developed as well as developing countries. At no point does it question the very tenets upon which the regime rests and what stability, efficiency and participation mean within this context. The risk is that without a rethinking of the fundamental tenets and concepts of current global financial governance, a further inclusion of other countries and stakeholder groups will only serve to further constrain regulatory solutions into the existing framework and make alternative choices harder to bring forward.

The third explanatory model proposes to rethink why certain issues are formulated and perceived as problems while others are not. The policy option that stems from this perspective is to challenge the entire structure of meaning within which regulatory discussions take place – in other words, to challenge the prevailing regulatory discourse. Of the three explanations, the third one is conducive to policy options that are able to challenge the very foundations of the current neo-liberal framework of regulation. Understanding the structure of meaning within which decisions and non-decisions are taken implies a critical engagement with (a) economic and financial theory, (b) market practice, and (c) domestic legislation. This cannot be done with the second explanatory model: despite the importance of showing the way in which the US administration or private financial players are dominant, this model does not make it possible to go beyond the current framework of regulation.

Issues of method

The methodological approach adopted in this thesis stems from the theoretical framework illustrated above. The previous section adopted three *explanatory models* to account for the outcome of the regulatory debate on hedge funds. The meaning that is assigned to the word 'explanation' thus becomes key to understand the methodological choice.

In the International Relations literature, the word explanation has been loaded with a particular meaning. Following Hollis and Smith (1990), the IR literature has linked explanation to those approaches that study the social sciences according to the criteria of the natural sciences – what Marsh and Furlong call the 'scientific tradition' (Marsh and Furlong 2002: 19). Positivism and empiricism are usually associated with this position. Within it, explaining means detecting regularities in social behaviour and developing laws to predict this behaviour that hold across time and space. In the words of Hollis and Smith, this is an 'outsider's [story], told in the manner of the natural scientist seeking to explain the workings of nature and treating the human realm as part of nature' (Hollis and Smith 1990: 1). According to this view, the word explanation should be used only with reference to the first and partly the second accounts outlined in the previous section – the ones respectively drawing upon mainstream financial economics and the realist perspective. For the last account, the word *understanding* should rather be used. Understanding is associated with an insider's story (Hollis and Smith 1990: 1) or an *interpretist* tradition (Marsh and Furlong 2002: 20). This tradition posits that the world is socially constructed and that there are only insiders' stories that look at the *meaning* of behaviour rather than at the *laws* of behaviour.

At first sight the distinction between explaining and understanding suits this study: the economic approach takes market reality as given and does not question the meaning of actors' choices or the impact of certain investment strategies. It can be labelled as an explanation. The same could be said for those theories that take state interests as given and do not problematise the nature of the decision-making process. The third explanation instead centres on the structure of meaning, which shapes what is no longer a given reality. It can be labelled 'understanding'.

Yet the explanation/understanding distinction can be misleading. To start with, explanation and understanding are only 'two sides of the same narrative coin [...] – not incompatible as Hollis and Smith insist, but inseparable' (Suganami 1999: 372). As the Oxford dictionary writes, explaining something is making it understandable, 'making one's meaning clear and intelligible' (Oxford English Dictionary Online 1989). Second, it is not immediately apparent as to why there should be only two stories (explaining and understanding) as opposed to as many stories as there are to explain the social realm (Suganami 1999: 371; see also McCloskey 1995: 1320). Finally, with this distinction the word 'explanation' is devoid of its original meaning of 'accounting for something, giving an account of one's intentions and motives' (Oxford English Dictionary Online 1989) and is exclusively conceived in terms of causal explanations. If it is true that there is a difference between positivist kinds of explanations and more interpretative ones, the difference can be marked in other ways, for instance by clarifying case by case what the explanation aims at and whom it is for. From a political economy point of view, it makes more sense to follow Cox's distinction between critical theory and problem-solving theory, where the focus shifts to the *quo probes* of each type of explanation (Cox 1995). Following from these considerations, in the next chapters the word explanation will be used for any type of account, whether interpretist or positivist. The interests behind each explanation will be pointed out by looking at its policy implications.

This background gives rise to three methodological problems that are specific to the topic and subject area under discussion:

(1) the necessity of thoroughly engaging with economic and financial theories as well as market and regulatory practices;

(2) the challenge of using elite interviews to find out actor motivations, interests and strategies of power as well as to capture the way they draw upon and reproduce a certain structure of meaning; and

(3) the effort to account for the 'unsaid' in regulatory discourses.

Regarding the first point, since hedge funds have been dealt with mainly in the finance literature, it is necessary to understand financial theories and their influence on the representation of hedge funds. This follows from the theoretical position according to which economic theories form an episteme that defines what is scientifically possible and acceptable and hence constrains regulatory choices that draw upon this episteme. Within mainstream financial economics, hedge funds are mainly explained through the Efficient Market Hypothesis and the Theory of Arbitrage, both of which assign to them a positive role as enhancers of efficiency and rationality. The question thus is to assess to what extent these theories shaped the content of the policy recommendations concerning hedge fund regulation. In order to do so, the thesis first studies mainstream economic theories. Second, it analyses the regulatory documents prepared by international organisations (IMF, FSF, etc.) and by domestic agencies. Third, it analyses the influence of the former over the latter. This method is complemented by a series of 'learning interviews' with economists and business scholars. Learning interviews with investment managers, consultants, journalists and market analysts have also been essential to understand the specific hedge fund practices. A caveat about the criteria to classify interviews is necessary. Since many interviewees preferred to remain anonymous, a special system to classify them has been adopted, whose criteria are explained in the 'List of Interviewees' section.

The interpretation of economic and financial theories is mainly conducted in Chapters 2 and 3. Chapter 3 in particular shows how the overall theorisation of hedge funds has influenced their representation and hence the way in which they were analysed at the various regulatory tables. In addition to the theorisation of hedge funds, the thesis analyses the specific meaning of the concepts and principles that inform current regulatory arrangements – due diligence, self-assessment of risk, stability, efficiency, equilibrium, etc. – and shows how they shaped the regulatory structure or discourse within which issues of hedge funds were debated. This will be done in Chapter 5.

As stated in the previous section, the thesis argues that the outcome of the regulatory debate on hedge funds was both a consequence of the way they were theorised and of the interests of the participating actors. More to the point, these two aspects cannot be separated: according to Foucault's definition of discourse as apparatus, issues of power and knowledge are intrinsically related, so that 'there is no power relation without the correlative constitution of a field of knowledge, nor any knowledge that does not presuppose and constitute at the same time power relations' (Foucault 1991: 27). This calls for a joint analysis of the strategies of power present at the 'regulatory table' (intended in a broad sense as all those sites where the regulation of hedge funds is discussed) and of the structure of meaning within which these strategies were devised. In order to do this, it was essential to carry out a series of elite-interviews targeted at regulators. The aim of the elite interview process was twofold. On the one hand, it provided details of the strategies of power and the coalitions of interests that prevailed at the regulatory table. On the other hand, it provided evidence of the way actors drew upon and reproduced a certain structure of meaning.

Elite interviewing was crucial for agencies like the Financial Stability Forum, which manage their archival material according to a 30-year disclosure rule. This means that documents are not available for analysis and that the only option is to interview those that directly participated in the decision-making process. It has to be said, however, that even if official documents were available, they would not provide a full sense of the events and of the background negotiations that informed the decision-making process. Chapter 4 will show that, in those instances where official documents or reports are available, the actual will of participants diverged from the text of the documents. This was the case for the bills that were introduced to the US House of Representatives with the purpose of changing the regulatory regime of hedge funds. It was also the case with the FSF report, where many recommendations were formally included though participants did not intend to implement them. The only way to uncover these strategies of power was through interviews with direct participants. This approach was particularly successful in the analysis of the debate at the Financial Stability Forum. Given the limited number of officials sitting in the FSF Working Group on hedge funds, it was possible to interview almost all of them and cross-check their versions of the events. This gave a fairly thorough understanding of the strategies of power and the coalitions of interest at work.

In addition, the interview process was useful as a way of understanding how participants drew upon and reproduced a certain structure of meaning. Though this thesis accords a higher explanatory power to the structure of meaning in accounting for the outcome of the debate on hedge funds, it is clear that this structure is reproduced through the actions of agents. Interviewing these agents was an essential methodological complement to the analysis of texts and theories. This methodological choice was partly influenced by theories of structuration – the idea that agents and structure are mutually constituted (Giddens 1984; Archers 1982) – and some of their applications in the IR and IPE literature (Scholte 1993).

Finally, the theoretical framework stresses the importance of the 'unsaid', that is, what is either excluded from the regulatory agenda or prevented from being perceived as a problem. Foucault's definition of the unsaid provides a complement to Lukes's two-dimensional view of power. Instead of looking solely at what is *intentionally* kept outside the regulatory table, as the two-dimensional view of power does, this approach argues that issues can fail to be formulated because the structure of meaning in which actors operate prevents certain problems from being felt as such. Methodologically, this means looking at the issues that are not dealt with, at the questions that are not raised, at the problems that are not framed and at the reasons for these exclusions. The thesis brings in several examples. Chapter 5 deals with the piecemeal regulatory attention accorded to short selling, despite its crucial role in financial speculation, and with the lack of recommendations to address the impact of hedge fund activities on market integrity and dynamics in small economies/emerging markets. It is Chapter 6, however, that specifically focuses on the unsaid in the discourse of hedge funds. Chapter 6 analyses those industries and instruments that, though being the economic equivalents of hedge funds, have not been subject to scrutiny at either the regulatory table in Basel or in Washington. On the contrary, in many cases – such as derivatives – regulators and policy-makers took initiatives to foster the hedge fund mode of investing.

One further methodological caveat is important. The fact that the analysis of market practices and regulatory proposals is carried out by relying on a qualitative methodology does not mean that quantitative data is not considered, but only that quantitative methods such as regression analysis are not used. This is because they are not deemed crucial to analyse the issues of power that this thesis investigates. Statistical data is presented in Chapter 2 to point out the main trends in the hedge fund industry (number, capital under management and performance).

The contributions of this study to the field of IPE

At the time of writing, a thorough study of the regulatory debate on hedge funds is missing in the International Political Economy literature. Given the complex technical nature of the market practice of hedge funds, it is not surprising that, despite the popularity they have acquired since 1998, not much has been done to understand their working and the political issues they trigger. This research, therefore, represents an original contribution in terms of novelty of the empirical material and topic of study. The research provides an empirical contribution via interview and documentary material that has not been undertaken before. A further contribution comes from the approach used to study hedge funds. It represents a clear alternative to the approach pursued in Business Schools and Finance departments. The main difference rests on the focus of these two types of study. The political economy approach adopted here centres on the analysis of power. A Business Studies approach is centred on the analysis of performance. This thesis can also be viewed as a contribution to cross-disciplinarity, as it draws on fields as diverse as Politics, IR, Law, Economics, Finance and Sociology, and analyses what they can offer to the study of financial market regulation in IPE.

Having established the empirical originality of the study, however, there remains the question concerning whether this research is *relevant* for the field of IPE. How does it contribute to our knowledge of the politics of financial regulation?

The choice of topic stemmed from an initial concern with financial crises. The financial market turmoil of 1997 and 1998 brought renewed attention to the role of speculation and the activities of speculators. Moreover, in 1999 a series of initiatives to reform what came to be known as the Global Financial Architecture were undertaken – one of which was the debate on hedge funds.

These events established the importance of placing the operation of financial markets and their regulation under a closer political scrutiny. It also became clear that the real political challenge did not rest in the analysis of financial crises as sporadic destabilising events, but in the study of the sources of crisis imminent in financial markets and in the day-to-day erosion of wealth that certain investment strategies produce. In other words, it became clear that a study of the mechanisms and instruments of financial speculation was much needed to understand the new modalities by which wealth is created and distributed/re-distributed in the world economy. This dissertation provides an analysis of one such mechanism and the debate over how to regulate it.

Originality also stems from looking at speculative instruments from a political and non-technical point of view. This is the main distinction between an IPE and a Business Studies approach. This thesis argues that a more politically informed analysis of financial issues could lead to more progressive regulatory proposals. A 'politically-informed' analysis is defined as an analysis that takes account of normative questions such as equity and democratic accountability. This contrasts with approaches in positivist economics that primarily address issues of efficiency and stability.

A political analysis starts by reviewing issues of power in financial markets. The concept of power that is applied to describe the outcomes of regulatory processes and the governance of global finance in general has increasingly moved away from a state-centred approach. The IPE literature has explored power as it stems from particular institutional settings (e.g. institutional perspectives, regime analysis) and from the structure of the global economy (e.g. structural power of capital in Strange and neo-Gramscian IPE). Less emphasis has been placed on the structure of meaning within which discussions take place and within which problems are framed. This thesis explores the contribution of Foucault's concept of 'discourse as apparatus' and post-structuralist notions of power in general to understand the current governance of

financial markets. Post-structuralism looks at how meaning and values are created in discourse and how this discourse constitutes a structure that promotes certain interests and inhibits others. Power, for instance, is exercised by attributing to hedge funds an efficiency-enhancing role or by prioritising due-diligence or self-assessment of risk over more mandatory approaches to regulation. Comparatively little has been done to understand how structures of meaning shape the working and the regulation of financial markets. This study, therefore, can contribute to the post-structuralist IPE literature on global financial governance.

A politically informed analysis of financial issues should, in theory, also enrich the Finance literature. It could promote, if not an interdisciplinary account, at least a conversation between disciplines that deal with the same subject area. Apart from Finance and International Political Economy, this thesis also draws on contributions from Law and Economics. The contribution of disciplines like Sociology and the Humanities (e.g. discourse analysis) is mediated through their application in International Political Economy.

The trend towards cross-disciplinarity in the study of financial markets is marked by several initiatives that have grown up around economics and finance, which this study has substantially drawn upon. In particular, this thesis has drawn from the following initiatives and approaches: the *Association for Heterodox Economics* (AHE), the *Post-Autistic Economics* (PAE) movement, and the *Alternative Perspectives on Finance and Accounting Journal.* In different ways, they all integrate contributions from heterodox perspectives in economics, including Marxism and Keynesianism, with historical, geographical, sociological and political perspectives. These alternative approaches have provided suggestions to evaluate regulatory proposals according to criteria other than the efficiency principle, which is the main guiding rule of positive economics.

Structure of the thesis

The thesis develops through six chapters. The first chapter outlines the theoretical framework while the following ones develop it empirically. After having explored the shortcomings of the *first explanatory model* (the one provided by mainstream financial economics), Chapter 1 develops a political economy approach to the regulatory problem of hedge funds by applying Lukes's three-dimensional views of power. By drawing upon Lukes's one- and two-dimensional views, the *second explanatory model* looks at the role of actors and institutions in influencing the hedge fund debate in Basel and Washington. By drawing upon the three-dimensional view, the *third explanatory model* looks at the role of the structure of meaning in shaping the content and outcome of this debate. Chapter 1 develops these two political economy models by considering approaches in IPE that can be associated with each of Lukes's dimensions: realism and neo-realism are associated with the one-dimensional view; regime theory and various strands of institutionalism are associated with the two-dimensional view; and neo-Gramscian and post-structuralist approaches to IPE are associated with the three-dimensional view.

Chapter 2 looks at facts and numbers about hedge funds as they are portrayed in the finance literature: what they are, how many they are, what they do, where they operate, which instruments they use, which performance results they achieve and when and why they began to be debated. Thus, the chapter starts by dealing with the first explanatory model and its main tenets and contradictions, which are then explored in greater detail in Chapter 3.

Chapter 3 argues that facts and numbers about hedge funds are not enough. More specifically, facts and numbers as reported in studies of hedge funds are already part of an interpretation, that is, of a political position. This interpretation has to be made explicit. It is argued that three aspects of this dominant interpretation influenced the way hedge funds have been addressed at

the regulatory table: (1) hedge funds as efficiency-enhancing mechanisms; (2) hedge funds as predominantly offshore entities – or entities that can move offshore should regulation be tightened; and (3) hedge funds as different, exceptional or alternative asset management schemes, which break from traditional investors. The chapter describes each of these aspects, their biases and the interests they are likely to foster. These features of the dominant representation of hedge funds and the biases they reproduce constitute the 'hedge fund discourse'. Chapter 5 will show how this discourse perfectly fits a market-led understanding of regulation and how both aspects contributed to leave hedge funds unregulated.

Chapter 4 explores the second explanatory model, which argues that the debate was influenced by the distribution of power at the regulatory table. Hedge funds have been left unregulated because the dominant actors (*US regulatory complex and transnational financial community*) did not favour a more interventionist regulation and because the rule-making procedures at both the domestic and international levels were simply instruments for advancing the interests of the strong. After a brief historical introduction of the regulatory debate on hedge funds, the chapter is split into three main parts. The first looks at the actors gathered at the Financial Stability Forum. It begins from a realist understanding of the FSF debate and gradually moves towards a more complex analysis of the coalition of interests, which includes both public and private actors. The second part deals with the domestic aggregation of the US interest that was championed in Basel and studies in detail the initiatives undertaken in the US to address the issue of hedge funds. The third part looks at the institutional setting of the debate and in particular at the rule-making procedures at the Financial Stability Forum.

Chapter 5 deals with the third explanatory model and shows that decisions were taken and recommendations were formulated by drawing on a particular structure of meaning. In addition to the representation of hedge funds as efficiency-enhancers, offshore entities and different or

exceptional vehicles (Chapter 3), four elements or 'co-ordinates of knowledge' of this structure are identified: (1) confidence in the working of an equilibrium market and its disciplining effect; (2) financial instability as the main preoccupation of the current market-led system; (3) due diligence as the new form of governance in financial markets – and the main tool to reach financial stability; (4) and an individualistic idea of risk. On the whole, these features are generally associated with neo-liberal views about the economy. This structure of meaning provided both direction and justification to the regulatory choices that were made in Basel. In particular, it limited what was considered 'scientifically' possible from a regulatory point of view; the kind of alternatives that other countries (e.g. emerging markets) could bring forward; and the identification of other issues and/or actors as stakeholders of the debate. This chapter also shows the interplay between this structure of meaning and the coalition of interests described in Chapter 4.

Chapter 6 continues the analysis of the structure of meaning by exploring the concept of the 'unsaid', which is an essential element of the definition of discourse as apparatus. In particular, the chapter shows that there is a further modality by which regulators have 'blessed' hedge funds: while debating on hedge funds' responsibility in disrupting market integrity and posing challenges to systemic stability, in other contexts the very techniques that hedge funds use have been promoted and legitimised. The unsaid in the discourse of hedge fund regulation materialised in the promotion of hedge fund-like modes of trading for a broader range of investors, including those institutional investors that collect money from the public (mutual and pension funds and insurance companies). The chapter considers recent US legislation on derivatives as well as developments in the mutual fund industry to show how hedge fund techniques in these industries have been promoted instead of being tamed.

The Conclusion discusses both the limitations of this study and its relevance for future research on the governance of global finance. Among the contributions of the thesis, the analysis of the structure of meaning is particularly productive. By problematizing the underlying tenets of the current discourse on financial stability, this study allows for a rethinking of the mechanisms of financial governance that have been created since 1997 and 1998. Outside the specific case of hedge funds, this analysis can be applied to other debates and fora that have been set up to discuss the reform of the Global Financial Architecture (GFA). More research is warranted on the contribution of Foucault's concept of apparatus and whether it could represent an empirically valuable synthesis of interest-based and meaning-based approaches to the study of the international political economy.

CHAPTER 1

EXPLAINING REGULATORY DECISIONS IN GLOBAL FINANCE:

Three Explanatory Models of Power

1.1 Introduction and structure of the chapter

This chapter provides a theoretical framework to explain the outcome of the regulatory debate on hedge funds. It does so by bringing forward three explanatory models, which will be dealt with in the following three sections. The theoretical and methodological meaning that this thesis assigns to the word 'explanation' is examined in the Introduction. What should be remembered here is that each explanatory model promotes a particular interest and suggests a particular set of policy options. The first model has been the dominant one in regulatory circles at both the international and domestic level and among mainstream economists. The other two models put forward a political economy approach of the kind that is developed in this thesis and explicitly introduce the politics of the debate.

The *first model* says that hedge funds have been left essentially untouched because the empirical evidence on them did not point to the need for a more pervasive regulation. In other words, facts and numbers did not show that hedge funds were a threat to the market. On the contrary, their role in promoting market efficiency was repeatedly stressed. This explanation is emblematic of the mainstream economic mode of enquiry, which does not question the objectivity of the empirical evidence and its theorisation in Economics, but instead affirms the scientific nature of economic investigation. By so doing, it abstracts from the specific context of the debate and in particular from the fact that it was certain actors within certain institutions and within a certain structure of meaning that took the decision not to regulate hedge funds. More to the point, this

account abstracts from any concept and content of power. This does not mean, however, that it remains above competing claims, that is, that it does not promote an interest or concern over others: behind the call for efficiency, mainstream finance explanations defend a self-regulating market in general and the *status quo* in financial markets in particular. This explanation was dominant in the regulatory circles of the IMF, the Financial Stability Forum, and domestic agencies in the US (e.g. the Securities and Exchange Commission and the Commodity Futures Trading Commission).

The *second model* focuses on the role played by the actors gathered at the Financial Stability Forum in Basel. Following Steven Lukes's definition of the one-dimensional view of power (Lukes 1974: 234-236), the focus is on the decision-making process, which evidenced a conflict between competing interests and where one set of recommendations prevailed over others. In the IPE literature, the realist and neo-realist perspectives best capture this concept. Within these perspectives, the FSF debate would be analysed in terms of inter-state diplomatic relations. With each state trying to maximise its own interest, the outcome of the debate would be the result of the direct power of participating states, with the dominant one (the US) prevailing. This explanation brings us to a consideration of the nature of US power, which in the IPE literature has been mainly dealt with through the hegemonic stability debate. This theoretical debate asks whether the US hegemony persists or is declining, whether it is conducive to international institutions that provide for public goods or instead to institutions that enforce the will of the strong. Issues of power are explicitly accounted for and highlight the conflict of interests between states or groups of states (e.g. G-7 countries on the one hand and emerging markets on the other).

Yet this perspective overlooks the fact that states are not the only actors involved in financial market regulation and, in any case, that each state cannot be analysed monolithically as the

expression of a common unified interest. The domestic debate in the US reveals that the formation of the 'US interest' with regards to hedge funds occurred via the prevalence of one group (the financial community) over others. The domestic aggregation of interests and the links between these domestic interests and international (or transnational) forces is not accounted for in the realist perspective.

By expanding the theoretical framework to include Lukes's two-dimensional view of power (Lukes 1974: 237-240), the second model can account for the role of the institutional setting beyond interstate relations. This brings us to consideration of those IPE approaches that have dealt with the role of institutions, mainly regime theories and institutional perspectives. In particular, it can be asked whether institutions are able to challenge the dominant powers or whether they are only yet another way by which dominant actors impose their will: by setting up institutional settings that are beneficial to the interest of the stronger, institutions can become a way to keep uncomfortable issues outside the regulatory agenda and to prevent any decision on them.

Though adding an important component to the one-dimensional view, the two-dimensional view still confines accounts of power to situations of overt (one-dimensional) or covert (two-dimensional) conflicts, where a decision or a non-decision has to be taken (Lukes 1974: 240; see also Lukes 1977: 3-29; and 1986). It forbids an analysis of power in all those situations in which a conflict is not present and it is the very formation of grievances and claims giving raise to conflicts that is prevented altogether. While opening up important perspectives on power, the two-dimensional view might have a limited value in the formulation of policy solutions. It is not only a question of establishing a more balanced decision-making setting (e.g. more representation from developing countries in international forum and organisations). It is first and foremost a question of understanding the reasons why certain issues are not brought

forward and why they remain marginal even in the agenda of non-dominant actors. The third model deals with those questions.

Drawing upon Lukes's three-dimensional view of power (Lukes 1974: 240-243), the *third model* says that deliberate struggles to keep grievances outside the policy agenda might be unnecessary if grievances are prevented from being formulated and perceived as such in the first place. Things get excluded from the political or regulatory agenda, not only because some actors *intentionally* oppose them or prevent them from being spoken about, but also because of the structural power of the framework of meaning within which discussions take place. Instead of looking solely at what actors keep outside the policy-making or regulatory table – as the two-dimensional view of power does – the three-dimensional view reflects upon the fact that only certain problems can be thought of to begin with.

In this way, the third model gives the three-dimensional view of power a post-structuralist twist. It introduces the concept of *regulation-as-discourse*, according to which the structure of meaning within which discussions are carried out and issues perceived sets limits to what can be said. Grievances and claims, in other words, can be formulated only when they have become part of a discourse. What gets excluded from a discourse will be defined as the 'unsaid'. The concept of unsaid in Foucault's definition of apparatus will be turned into a heuristic tool to challenge the dominant regulatory approach to hedge funds.

The chapter argues that of the three models only the third one can lead to policy solutions that provide a real alternative to the current neo-liberal framework of regulation. The concept of discourse, and especially Foucault's definition of discourse as apparatus (Foucault 1980), is one of the most promising routes to question the structure of meaning within which decisions and

non-decisions are taken. In this specific case, it provides a heuristic tool to critically engage with mainstream economic explanations of the kind described in Section 1.2.

Table 1.1 summarises the main features of these three explanatory models and indicates how each of them provides different policy options to reform regulatory practices in finance.

Table 1.1. Explaining the regulatory debate on hedge funds

Explanatory Model	Main aspects of the explanation
First explanatory model: empirical evidence It draws on mainstream financial theory and practice	Empirical evidence does not point to the need to regulate hedge funds. This mode of explanation claims objectivity and value-free foundations. No questioning of method or epistemology. Methodology models itself upon the natural scientist unearthing the laws of nature (positivist economics). No issues of power considered. Policy options: market-driven regulation through private actors' due diligence and self-assessment of risk. Market actors (banks) should be delegated the power to supervise and monitor hedge funds.
Second explanatory model: power of actors and of the institutional setting It draws on Lukes's one- and two-dimensional views of power	Actors meeting at the Financial Stability Forum in Basel took the decision not to regulate hedge funds. Actors reflect state interests in the pursuit of self-maximising goals. Interests are revealed in conflicts, which can be overt or covert. More powerful actors/states imposed the decision to leave hedge funds unregulated. Non-decisions may be considered, as well as the role of the institutions that were set up by actors to deal with the problem. Power prevalently conceived as power of individuals. Policy options: re-balancing the distribution of power at the regulatory table – e.g. more representation to emerging markets and developing countries in international negotiations; more representation to trade unions and civil society groups in domestic discussions of global finance.
Third explanatory model: power of the structure of meaning It draws on Lukes's three-dimensional view of power	Both regulatory problems *and* solutions stem from the structure of meaning within which issues are discussed. An approach of *regulation-as-discourse* explains that this structure of meaning sets limits to what can be said. Grievances and claims can be formulated only when they

	have become part of a discourse. The 'unsaid' is part of the discourse as much as the said. Power is conceived as structural power – power of the structure of meaning. Policy options: challenging the framework of thought or apparatus that pervades the regulation of financial markets.

1.2 First explanatory model: the empirical evidence

> '...[As] a number of independent studies [...] [have] suggested, the activities of highly leveraged institutions do not appear to have played a significant role in precipitating the financial market crises of the past few years' (The President's Working Group on Financial Markets 1999: xiv)

The first model explains the outcome of the regulatory debate on hedge funds by saying that economists and regulators did not find substantial empirical arguments to justify a more mandatory approach to their regulation. 'Facts and numbers' about hedge funds – this account says – did not point to the necessity of regulating them. This section first shows the main arguments in favour of this thesis and then the reasons to believe that facts and numbers about hedge funds might not be enough.

To begin with, the number and capital of hedge funds are considered to be limited compared to those of other market players. In addition, hedge funds are said to be more likely to stabilise than destabilise market equilibrium. By acting as market contrarians,[1] the argument goes, they bring efficiency and liquidity to the market. Finally, hedge funds were not found guilty of speculating against Southeast Asian currencies during the crucial months leading up to their currency devaluation. Some studies even found that hedge funds were holding and not shorting the currencies of the affected countries (Brown et al. 1998).

[1] Doing 'contrarian investing' means doing the opposite of what other investors do. See Glossary.

This explanation was first advanced in the IMF Occasional Paper *Hedge Funds and Financial Market Dynamics* (May 1998), which was prepared by a team of IMF economists led by Barry Eichengreen, and in a working paper of the National Bureau of Economic Research (Brown et al., May 1998). These two papers appeared in the aftermath of the Asian financial crisis and greatly influenced the first phase of the debate on hedge funds. In 1998, the regulatory debate on hedge funds started with the idea that hedge funds were a false problem. Later this evidence was partly revised by the work of the Financial Stability Forum Task Force (FSF 2000), which acknowledged that hedge funds most likely played a role in the devaluations in Asia and other emerging markets during 1997 and 1998. Yet the idea that hedge funds are 'on average' a stabilising force and a minority component of the investment community (Greenspan' and McDonough's statements, Committee on Banking and Financial Services 1998: 29 and 40) remained unchanged throughout the evolution of the debate and profoundly influenced the recommendations that were put forward both at the domestic and the international level. The report of the US President's Working Group (PWG)[2] provides an example of it, as the opening quotation demonstrates.

Similar considerations were made in the case of LTCM, though LTCM brought up a different set of concerns – mainly the concern that a large and leveraged hedge fund could collapse and bring down with it a good part of the financial system. The near-failure of LTCM was mostly explained as the result of an unexpected external shock (the Russian debt default) and not as the consequence of aggressive trading strategies. This explanation was dominant among academics and regulators (Greenspan' and McDonough's statements, Committee on Banking and Financial Services 1998: 29 and 40; Stonham 1999b: 384). Both William J. McDonough, President of the Federal Reserve Bank of New York and Alan Greenspan, Chairman of the Board of Governors

[2] The President's Working Group on Financial Markets (PWG) gathers representatives of the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Treasury

of the Federal Reserve System, suggested that LTCM was an exception and that in general hedge funds do not represent a threat for the financial system (Committee on Banking and Financial Services 1998: 29 and 40).

Overall, economists and regulators argued that an excessive alarmism gathered around hedge funds, while the empirical evidence suggested that their regulation was either unnecessary or unfeasible. This section shows that it was not objective numbers and facts about hedge funds – the empirical evidence – that motivated this view. First, such numbers and facts do not always exist, as no reporting requirement is imposed upon hedge funds. Data are only available through interviews with managers and the information they voluntarily release. Second, even when this evidence is available – e.g. in the case of LTCM, where information could be collected ex-post from its counterparties – data can still be interpreted in different ways. The hypothesis that LTCM was an exception brought about by unfortunate international circumstances was as plausible as other assumptions – including the assumption that hedge funds represent a destabilising force in financial markets because of their aggressive trading strategies and the size of their leveraged positions.

In other words, the problem was not only one of lack of data, but also and principally of *interpretation* of data. The crucial question, therefore, concerns the degree of trust we are willing to concede to economic quantitative analyses. Given that these analyses are often the basis for policy solutions, this question needs to be taken seriously.

The relationship between the empirical evidence and the processing of this evidence by mainstream Economics is particularly problematic. A growing section of the IPE literature has displayed mistrust for mainstream economic and financial studies. With the exception of those

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and the Board of Governors of the Federal Reserve System.

approaches that take Economics as a model for the rest of the social sciences (see for instance Waltz 1979 and in general neo-realist perspectives), IPE is increasingly critical of the explanations provided by Business Schools and Economics Departments. Critical voices in IPE usually come from one of the following traditions: critical theory, and especially Marxist and neo-Gramscian approaches (see for instance Linklater 1996; Cox 1995; Gill 1988), and post-structuralism (see for instance George 1994; Derderian 1989; Shapiro 1989; Smith 1996; Smith 1997). For the sake of this discussion, they will be grouped together and identified as 'critical IPE'.[3]

A suspicion towards economics can be said to go back to the moment in which politics became separated from economics during the marginalist revolution (1870s). Since the introduction of positivism in economics in the 1930s and especially since the publication in 1953 of Friedman's *Methodology of Positive Economics* the needs and aims of Political Economy and Economics have become even more irreconcilable. In general, what critical IPE opposes to Economics is its enduring positivist stance. This can be summarised in the call for objectivity and value-free foundations and in the claim to deliver the *one* true knowledge of the *one* real world. This call for objectivity went hand in hand with the rejection of the 'political' in economic explanations. The political is here intended as the morality-, interest- or subject-dependent standpoint in scientific explanations, that is, as the negation of value-free foundations.

Positivism appealed to Economics for the same reasons that Nicholson brought forward for International Relations:

> 'International Relations concern issues over which we have strong moral feelings... This makes it all the more important that we have rigorous criteria for distinguishing

[3] Though most of these authors are IR scholars, their approaches have greatly influenced theoretical developments in IPE. For this reason it can be said that a critical IPE draws on their scholarship.

between what is the case in the world and what we want to be the case' (Nicholson 1996:141).

This echoed Friedman's opening in his *Essays in Positive Economics*, where he distinguishes between normative and positive economics: 'positive economics is in principle independent of any particular ethical position or normative judgements... [it] is or can be an 'objective' science, in precisely the same sense as any of the physical sciences' (Friedman 1953: 4). Positivist economics, in other words, claimed to provide the 'what is the case' instead of the 'what we want to be the case' explanation. The remainder of the section explores whether this claim of objectivity can indeed be sustained. It does so through a brief history of positivism in Economics. It points out that the claim is contested not just because it is difficult to sustain that there are facts out there independent of interpretation, but also because Economics maintains the objectivity of its theory and assumptions and not only of the facts under enquiry.

The introduction of positivism in Economics is generally attributed to Terence Hutchison in the 1930s (Caldwell 1994). Hutchison's position was enormously influenced by his frequentation of the Vienna Circle of *logical positivists* in the 1920s. His positivism can be summarised in three main points. First, as a science Economics must appeal to facts (Caldwell 1994: 107). Second, economic propositions 'must conceivably be capable of empirical testing or be reducible to such propositions by logical or mathematical deduction' (Hutchison 1960: 9, cited in Caldwell 1994: 107). Third, the scope of Economics as a science is the search for empirical regularities (Hutchison 1977: 8-33).

The logical positivists of the Vienna Circle (1920s) justified their fear and distrust of the political – intended as the biased and irrational – against 'the nationalist hysteria, the sinister cult of the irrational and power that in Hitler's Germany was reaching its apex' (Caldwell 1994: 106). Logical positivism argued that science (both natural and social science) should only deal

with phenomena that are directly observable. Cognitive significance (or epistemological significance) was only attributable to those statements that could be falsified or verified by experience. The insistence on the primacy of observational evidence ruled out the 'notion of causal laws explaining observable phenomena as metaphysical and therefore unscientific' (Smith 1996: 15). Theories were reduced to instruments, neither true nor false, but adequate tools to establish correlations among phenomena. Description was privileged over explanation. The ontological claim was that there is *a* reality out there independent of interpretation and that this reality can be known by *direct* empirical test (Caldwell 1994: 11-35).

Between the 1930s and the 1950s a less radical positivism emerged with the name of *logical empiricism*. The criterion according to which statements are meaningful - and scientific - only when completely verified by observational evidence was felt too limiting for research. The solution adopted by the logical empiricists was the 'hypothetico-deductive' model' (Caldwell 1994: 23), according to which not all the statements in a theory have to be tested against reality in order for the theory to be empirically verified. Contrary to the early positivists, logical empiricists maintained that theories are more than organisational tools to describe phenomena. Theories explain and do not only describe (ibid: 29). There is a reality out there that can still be assessed empirically, but only through the use of the hypothetico-deductive model, which accords scientific significance to both data and *a priori* statements. This approach justified the use of 'ideal types' (such as the rational maximising individual) without the necessity of testing their empirical validity. This means that a fundamental role is attributed to theory and not only to facts. This implies that if knowledge is to be proved objective one needs to justify the objectivity of the theory (e.g. rationality criteria) and not only the (more seemingly straightforward) objectivity of facts.

This tendency became more marked with Friedman's *Methodology of Positive Economics*. His assertion that in judging the significance of a theory the *realism* of its assumptions (i.e. their correspondence to reality) does not matter significantly undermined positivist economics' claim to provide an objective representation of reality. 'Truly important and significant hypotheses, Friedman writes, will be found to have "assumptions" that are wildly inaccurate descriptive representations of reality and, in general, the more significant the theory, the more unrealistic the assumptions' (Friedman 1953: 14). The link with 'facts' is definitely broken. Indeed Friedman writes that the ultimate purpose of theory is to predict, not to describe or to explain: even if its assumptions are an 'inaccurate descriptive representation of reality', a theory may still be able to deliver accurate predictions of that reality.

It is clear, therefore, that positivism in Economics has rested as much on empiricism as on rationalism. It is not, as Smith defines it,[4] 'a methodological position reliant on an *empiricist* epistemology which grounds our knowledge of the world in justification by (ultimate brute) experience' (Smith 1996: 17, my italics). Positivism in Economics has relied on empiricism only in the 'official' rhetoric, so as to claim objective knowledge because of its foundations in the real world. In actual fact, positivism in Economics has rested on a mixture of empiricism and rationalism, the latter being dominant in the last 50 years. This means that the claim to objectivity cannot be justified by referring to brute facts 'out there'. It must maintain that the theory is objective, which is obviously very difficult to do.

This has important consequences for the initial inquiry: saying that the empirical evidence on hedge funds did not point to the need for their regulation is not an objective statement. This is not only because of imperfect data, but also because of the way the data is processed, which is

[4] Smith definition refers to positivism in the social sciences in general.

far from objective. It follows that appealing to the empirical evidence to argue that hedge funds should not be regulated means talking from a precise political and value-loaded position. Following this line of enquiry, Chapters 2 and 3 will question financial economic theories on hedge funds in order to highlight the interest they promote.

To conclude, it becomes difficult to accept Friedman's claim that 'currently in the Western world [...] differences about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action – differences that in principle can be eliminated by the progress of positive economics – rather than from fundamental differences in basic values...' (Friedman 1953: 5). This chapter maintains the opposite view, that is, that different basic values underpin different empirical analyses. Instead of working for the progress of positive economics, more effort should be devoted to furthering the knowledge of the principles that underpin policy prescriptions. This would help to understand why alternative values have not been included in the contemporary academic and policy agenda. It would also help to introduce considerations of power into economic theories, which, as Strange pointed out, 'ignore power altogether' (Strange 1999 [1988]: 28).

1.3 Second explanatory model: relational power

This section argues that the outcome of the regulatory debate on hedge funds cannot be attributed solely to the lack of empirical evidence against hedge funds. This explanation abstracts from the reality of the decision-making process and does not consider that it was specific actors within specific institutions that took the decisions to leave hedge funds essentially unregulated. In other words, the analysis must consider the distribution of *power* at

the FSF regulatory table, which includes both the power of actors and of the institutional setting in which the debate took place.

1.3.1 Lukes's one-dimensional power and the realist explanation in IPE

This section provides an explanation that draws upon the definition of decision-making power as re-elaborated by Steven Lukes in *Power: A Radical View* (1974). Formulated by American social scientist Robert Dahl and the so-called pluralists in the late 1950s-early 1960s, this concept of power says that 'A has power over B to the extent that he can get B to do something that B would not otherwise do' (Dahl cited in Lukes 1974: 234). The stress is on the exercise of power in direct – that is actual and observable – situations of conflicts. This power is said to be best caught in decision-making situations: 'the focus on observable behaviour in identifying power – Lukes writes – involves the pluralists in studying decision-making as their central task' (Lukes 1974: 235). Dahl applies his insights to key political decisions taken in the community of New Haven in the 1950s. Decisions for Dahl are about key issue areas, which are controversial and involve actual disagreement and conflict of interests among two or more groups. Interests are defined as preferences, 'that are assumed to be consciously made, exhibited in actions, and thus to be discovered by observing people's behaviour' (Lukes 1974: 236). To sum up, Lukes calls Dahl's position the *one-dimensional view* of power and sees it as involving 'a focus on *behaviour* in the making of *decisions* on *issues* over which there is an observable *conflict* of (subjective) *interests*, seen as expressed policy preferences, revealed by political participation (Lukes 1974: 236).

The IPE literature has mostly conceived of this type of power as *coercive* power and has relegated it to the sole interest of realist scholars. Susan Strange calls it *relational* power and defines it as the kind of power 'conventionally described by realist writers of textbooks on international relations' (Strange 1999 [1988]: 24). She gives as an example the fact that '[in]

1940 German relational power made Sweden allow German troops to pass through her 'neutral' territory' (ibid). This does not only allude to the direct nature of power (Germany being able to get Sweden to do something it would not otherwise do) but also to the realist assumption that the state is the primary unit of analysis and conflict among states the rule in international relations. (Among classical realist thinkers in IR see Morgenthau 1993 [1948] and Carr 1946 [1939]. For a review of realism in IPE see for instance Frieden and Lake 2000: 12-13; Keohane 1984: 5-17; Gill and Law 1988: 25-40.) Stephen Gill calls it 'power over' or 'direct power' (Gill 1990: 63; Gill and Law 1988: 84). Like Strange, he links it to the idea of coercion – 'power over, *macht* or domination' – and associates it with intentional action (Gill 1990: 63). Both Gill and Strange see this power as of little help in understanding the international political economy. Strange writes: 'In the competitive games now being played out in the world system between states and between economic enterprises, it is increasingly structural power that counts far more than relational power' (Strange 1999 [1988]: 24).

A realist approach would explain the regulatory debate on hedge funds as a case of inter-state negotiations over an issue on which states display conflictual interests. It assumes that the state as the main unit of analysis is homogeneous in the pursuit of its 'national interest', with no discrepancies in the aggregation and definition of this interest. The FSF Working Group on hedge funds would thus be seen as a forum of states promoting their own national interest.

As Chapter 4 will describe, the FSF counts, among its members, representatives of G-7 countries plus the Netherlands, Australia and Hong Kong. Australia and Hong Kong represent those countries that in 1997 and 1998 were most affected by the activities of hedge funds, while the US is the country where most hedge funds are managed. During the negotiations, the latter was against tighter regulation of hedge funds, while the former strongly called for an international response to the financial crises in emerging markets via the regulation of hedge

funds. The US got the full support of the UK and the Netherlands, while Germany and France often joined emerging markets in the call for a more mandatory approach to regulation. Officials interviewed in Basel (Anonymous 5, interview 2003) as well as members of the FSF Working Group (Anonymous 1, interview 2003; Anonymous 2, interview 2003; Anonymous 11, interview 2003; Anonymous 10, interview 2003) stressed the ability of the US to impose its own recommendations and veto any unwanted proposition. Chapter 4 will show how many proposals to introduce surveillance mechanisms on the activity of hedge funds were strongly opposed by the US representatives and were eventually taken out of the final report. According to the definition of relational power, the US was able to get the other states at the regulatory table to do something they would have not otherwise done.

So, at first sight, the realist perspective has great explanatory purchase. Yet this leaves many questions unanswered. First, why was the US able to impose its way, that is, what is the nature of its power (coercion, persuasion, etc.)? Second, what is the US 'national interest' in leaving hedge funds unregulated? Any attempt to answer these questions implicitly undermines the strength of the realist explanation.

The IPE literature has analysed the nature of US power and dealt with it mainly through the theoretical debate on hegemonic stability. In the 1980s, a common theme of US academic writings in International Relations was the claim that the US had lost the hegemonic position it held during the Bretton Woods period. This theory, which had in Paul Kennedy (1988), Robert Gilpin (1987), Robert Keohane (1984; 1989), and Stephen Krasner (1983) its most prominent proponents, came to be known as the *theory of hegemonic stability*. These authors shared the belief that the US hegemony was declining and that this would have negative consequences for world order and stability. Gilpin and Krasner argued forcefully that the US decline would undermine the leadership and stability of the world financial system. Gilpin writes: 'The

displacement of the United States by Japan as the dominant financial power and the global debt problem have raised troubling questions about the leadership and stability of the world financial system' (Gilpin 1987: 394). Keohane and Krasner are less gloomy on the prospects for world order and see the creation and maintenance of international institutions and regimes as a way to avert the risk of conflict and disorder (Keohane 1984: 31-32; Keohane and Nye 1989: 55; Krasner 1983). Outside the realist and neo-realist camps, Wallerstein also saw the end of US hegemony, which he interpreted as a crisis of capitalist production, as leading to instability in the world economy (Wallerstein 1984: 37-46).

Other IPE scholars opposed this idea of lost hegemony. Steven Gill argued that this view fails to acknowledge that the US can develop not only *conscious policies* to exercise domination over other countries, but also considerable structural power by virtue of its political, economic and military supremacy (Gill 1990: 64). 'In other words', Gill writes, 'the very size and weight of the United States within the international system substantially affects the conditions under which all other states and interests must operate' (ibid). From this structuralist perspective, the dominant player does not need to impose its power in any agential or intentional sense of the term. Similarly, Strange opposed the idea of the decline of US hegemony by pointing out that 'in this new great game of states, structural power decides outcomes (both positive and negative) much more than relational power does, and the United States' structural power has, on balance, increased' (Strange 1987: 553). The next sections will provide a more complex definition of structural power. For now it is important to mark the difference between this concept and relational/direct forms of power.

With regards to global finance, Strange's prediction of the continuity of US leadership was extremely accurate. As Eric Helleiner points out, 'with her insistence on America's enduring power in global finance, Strange stood quite alone in criticizing [the] widely held view of

Japan's financial clout by the late 1980s. [...] By the late 1990s, it was hard to deny that the United States had remained, as Strange (1982) put it, "still an extraordinary power" in world finance' (Helleiner 2000: 230). This runs opposite to what Gilpin wrote (see aforementioned quotation).

Going back to the FSF regulatory table, as the US did not use any coercive measure to get the other members of the FSF to comply with its will, it can be argued that structural power (Gill 1990; Strange 1987) more than relational power helped the US impose its will. This runs contrary to the definition of one-dimensional or relational view of power, which states that the analysis should be limited to what happens in a decision-making setting, to the sole observation of the behaviour of the actors involved and to the overt conflict occurring among them. In other words, it is difficult to justify the outcome of this regulatory debate on the basis of relational power alone. Relational power – and hence realist theory – does not exhaust the complexity of power relations inside and outside the decision-making setting.

There is a another reason why the realist view of power might be inadequate to understand the outcome of the regulatory debate on hedge funds. The 'national interest' of the realist explanation does not account for the process of domestic aggregation of this interest. States are seen as championing their own interest in international negotiations – which is generally justified with the pursuit of national security – as if this interest were compact and reflected the preferences of the majority of people in the country. It fails to consider how the national interest is aggregated and whether such a unitary, monolithic concept exists in the first place. In particular, it abstracts from the fact that there are conflicting domestic forces and that only one or a few of those forces might be represented in international negotiations (Gill 1990: 38-39). This was clearly the case with the regulatory debate on hedge funds: it was not the national

interest that was championed in Basel, but that of the most sophisticated and global section of the financial community.

To start with, the FSF Working Group on hedge funds is composed of representatives of domestic regulatory agencies, treasuries and central banks. The analysis, therefore, must focus on the interests that gather around these institutions at the domestic level. Regulatory agencies, central banks and treasuries are closely associated with the regulated. According to Underhill, 'relationships among regulators and their constituencies of market participants remain close [...]' (Underhill 1997: 5), so that these two sets of actors might be seen as a *closed policy community* (ibid: 24). Similarly, Gill talks of a 'banking complex' encompassing private and central banks, other regulatory agencies and financial institutions, prestigious universities, and influential members of the financial media (Gill 1990: 117). Underhill draws attention to forms of 'sectoral corporatism, particularly in the relationship between the Federal Reserve and the large 'money centre' banks and in the securities sector' (Underhill 1997: 24). Moreover, the co-operation between agencies and regulated is increasingly turning into a dependency. Referring to the Basel process, Underhill argues that '[banks'] many possibilities for innovative avoidance of regulatory provisions or prudential standards enhance the dependence of official agencies on the industry' (Underhill 1997: 25). This highlights how easily the regulated can promote their interest through regulators. (For an analysis of the capture and recapture of the state and regulatory processes by powerful domestic groups see also Moravcsik 1997.)

The agencies involved in the US debate on hedge funds were the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) – in charge respectively of securities and commodities regulation – the Federal Reserve (FED), and the Treasury. The President Working Group, which gathers the views of these four agencies, proposed both legislative and administrative changes to the regulatory regimes of hedge funds.

The legislative changes were meant to go through the Congress, while the administrative ones could be undertaken by the SEC and the CFTC without the Congress' approval.

The decision-making process at the US Congress did not see represented the whole range of interests at stake. To begin with, it could hardly be analysed through the one-dimensional view of power: no actual, observable conflict was apparent among Congressmen. Most of them approved the decision to change hedge funds' regulatory regime and no strong disagreement was evidenced. Yet the two bills that were introduced to the House of Representatives to endorse this objective were not enacted. It became evident that the intention of their proponents was not to pass them, but to send a signal that the issue was being taken care of, so that it could go out of the spotlight. What is more, these bills were not proposing major changes to the regulatory regimes of hedge funds: many provisions were biased because of inconsistencies with other parts of the regulatory system or because they required other changes to the broader legislation of investment companies that were not included in the bills. Even if implemented, those bills would have not brought about any substantive revision. The administrative changes at the SEC and CFTC had the same faith: no major revision was implemented.

The fieldwork evidenced that decisions were taken somewhere else and not during the decision-making process at the Congress. This substantiates what Underhill calls a 'legitimacy deficit' (Underhill 1997: 38-43). 'Unlike many policy issues', he writes, 'which involve open lobbying in a context of democratic accountability, the policy communities involved in financial regulation are self-contained, admitting only specialised regulatory and supervisory agencies, self-regulatory organisations and other industry associations, and market participants' (ibid: 39). Eventually, the unwillingness to regulate hedge funds – and with it the legitimacy deficit – moved from the domestic level in Washington to the international level in Basel. This highlights two major points: first, the 'national interest' that emerged from the US domestic process

favoured very specific groups (e.g. high finance); second, the US domestic process once more revealed that the one-dimensional view of power is unable to explain the complexity of power relations in a decision-making setting.

A final remark against the realist view of power is that it is not certain that the interest emerging from the domestic process in Washington and championed in Basel can be called 'national' either. Gill's concept of banking complex can be enlightening in this regard. Gill sees the banking complex as part of a wide 'transnational network' that encompasses and fosters the interests of financial fractions of capital (Gill 1990: 117). The financial community that lobbied the US Congress, in other words, cannot be qualified as a US community only. It is true that the US financial community is dominant in terms of structural conditions: location (Wall Street or Greenwich for that which concerns hedge funds); intellectuals ('often the best brains that money can buy', Gill 1990: 117); concentration of money and wealth (e.g. the role of the dollar in portfolio management);[5] and the most advanced financial know-how. It is also true that the financial community that regulators most often meet with is the one based in New York. This, however, should not obscure the fact that the financial community based in New York is transnational in character and serves the interests of the most affluent segment of the world population. After all, foreign banks and financial institutions based in the US have as close a link with US regulators as American firms. The US 'national interest' therefore is blurred with the interest of transnational financial capital. Only by equating the US national interest with the interest of its financial community and by expanding the latter to include broader transnational financial networks is it possible to continue to maintain that the US pursued its national interest in the negotiations over hedge funds.

[5] The dollar is still the most important currency. Most portfolios all around the world are denominated in dollars.

To conclude, it can be said that the realist perspective outlined in this section serves a useful purpose in pointing out the power of dominant states in decision-making processes at the international level. Yet it leaves many questions unanswered. By considering the state as the main unit of analysis and by seeing it pursuing a monolithic national interest, which is generally defined around the pursuit of national security and evidenced by state behaviour during overt decision-making process, this perspective misses the complexity of power relations in the governance of global finance. This section has shown that structural power, the domestic aggregation of interest, and the transnational nature of this interest are all crucial aspects that the realist perspective does not account for.

The next section expands this explanatory model by introducing the role of the institutions within which the debate took place. The debate in fact was hosted within specific institutions: the Bank for International Settlements and, within it, the Financial Stability Forum. The question to be asked is whether this institutional setting can be seen as separated from the interests of the states that set it up or whether it is just a mechanism to perpetuate those interests.

1.3.2 Lukes's two-dimensional view of power and the role of institutions in IPE

Lukes's *two-dimensional view of power* provides important clues to answer this question. In addition and partly in opposition to the one-dimensional view of power, Lukes argues that power can also be exercised by confining the scope of decision-making to relatively 'safe' issues, which render the actual decision-making process only partially representative of the interests at stake. Non-decisions, intended as the prevention of decisions, can be more important than actual decisions (Lukes 1974: 238). In particular, the two-dimensional view of power allows for an analysis of the institutions that are in place to keep certain issues outside the

political or regulatory agenda. As Bachrach and Baratz, to whom Lukes refers in his formulation of the two-dimensional power, say,

> Power is also exercised when A devotes his energy to creating or reinforcing social and political values and *institutional practices* that limit the scope of the political process to public consideration of only those issues which are comparatively innocuous to A. To the extent that A succeeds in doing this, B is prevented, for all practical purposes, from bringing to the fore any issue that might in their resolution be seriously detrimental to A's set of preferences (Bachrach and Baratz cited in Lukes 1974: 237, my italics).

IPE has addressed the role of institutions mainly through regime theory and institutionalism. Regime theorists see institutional settings like the FSF as mechanisms to counterbalance the decline of US hegemony and bring stability to the world system (Keohane 1989, Krasner 1983). Regimes are defined as sets of 'implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations' (Krasner 1983: 2). Yet, as Lukes's analysis suggests, this perspective overlooks the fact that regimes might be created to strengthen those principles, norms, rules and decision-making procedures that are more favourable to one actor or interest. In other words, the Basel process might not be the place where actors converge in a given area of international relations, but the place where issues are even more firmly constrained within the dominant paradigm of financial governance.

These concerns have also been addressed from various institutionalist perspectives, which all prioritise institutions as the main level of analysis and conceive of them as an intermediate level between the structure of the inter-state system and the state.[6] Referring specifically to the institutions that form the structure of global financial governance, some scholars consider them

[6] Institutions are herein equated with formal international organisations such as the IMF or the Financial Stability Forum and with the rules and norms governing these bodies. For a literature on new institutionalism in IPE see for instance Young 1996; Keohane 1988 and 1989; Goldstein and Keohane 1993. For a literature on historical institutionalism see Germain 1997 and 1999; Steinmo and Thelen 1992; for an attempt to synthesise the two literatures see Hall 1996 and 1998; and Hay and Wincott 1998.

to be able to challenge the interest of the dominant players (Germain 2002), while others wonder 'whether intergovernmental organizations originally designed to encourage mutually beneficial collaboration among sovereign member states were simply turning into crude instruments for advancing the interests of the strong' (Pauly 1999: 1). This section privileges the latter approach – which reflects Luke's two-dimensional view – and explains why the former is to be rejected in the case of the FSF Working Group on hedge funds.

Germain argues that 'the structure of financial governance has become both more global and more legitimate' (Germain 2002: 15) and that this can be evidenced by two main developments: first, the increased 'publicness' of financial governance and, second, its consensual nature. By increased publicness Germain means that discussions of financial governance have become less confined to elite-level deliberations. He writes that, 'even though the actual meetings of the FSF [...] are closed to immediate public scrutiny, the results of these meetings are published and an extensive system of outreach has been put in place to ensure a dialogue occurs among as wide a cross-section of the public as possible' (ibid). The second aspect is the turn towards a more consensual decision-making structure. Germain attributes this turn to the division of labor among different organizations (G-7, IMF, FSF, G-20), which are driven by different sets of dynamics and, most importantly, are independent from one another and from the government. He writes: 'This complex division of labor actively discourages coercion and encourages consensus as a key hallmark of international decision-making' (ibid: 16). Germain identifies these new developments (publicness and consensual decision-making) as the emergence of a 'public sphere' in global finance.

The present research makes a different argument. In particular, it shows how the publicness and consensual nature of the discussions carried out in Basel reflects the situation highlighted by

Lukes's two-dimensional view of power rather than the emergence of a more legitimate and democratic public sphere. Starting with the issue of publicness, what is made available is the final text of the recommendations taken by the various FSF groups and task forces (HLIs, capital flows and offshore centers) and the list of people sitting in those committees. This is certainly progress compared with only 10 years ago, when deliberations were carried out in total obscurity (ibid). Yet it does not mean that the debate is open to public scrutiny (e.g. the minutes of the meetings are not available). Moreover, interviews in Basel evidenced large discrepancies between the text of the reports and the participants' accounts of the meetings.

It is the consensual nature of the decision-making process, however, that proves more problematic. The Financial Stability Forum only works by consensus, which means that no decisions can be taken without the consensus of all participating members. This might in principle foreshadow a more democratic and legitimate system of global governance, as Germain argues, but it can also be a way to confine decision-making to 'safe issues', as Lukes says. In the case of the debate on hedge funds, countries began negotiating from very different starting points and did not considerably change their positions in the course of the process. A consensus in this situation could have been struck only at the cost of lowering the threshold of acceptability. As a member of the FSF Working Group on HLIs said, 'you reach a consensus by writing a report that says very little and whose final proposals are "hot air": everyone agrees on it, but its effectiveness is almost nil' (Anonymous 10, interview 2003). There is an issue of 'quality' of consensus that Germain's analysis does not account for. Consensus, in other words, is not automatically good because it is opposed to coercion. In addition, there are further grounds to be pessimistic about the modality of consensual decision-making. A consensus creates a set of guidelines that are supposed to be followed by both participating and non-participating countries. It creates, in other words, a 'regime', intended this time as the normalization of a previously contested issue rather than an order-supporting mechanism as in

neo-realist approaches. Cox's definition of regime as *institutionalised hegemony*, where institutionalisation is the means to stabilise and perpetuate a particular order (Cox 1986: 219), well illustrates the FSF process. The comment of an FSF official can enlighten this point. He said that, 'the aim of the FSF Working Group was to have a political consensus on what to do and put this issue to bed' (Anonymous 3, interview 2003). To paraphrase Edkins, consensus might produce a situation where issues 'are even more firmly constrained within the already accepted criteria of a specific social form' (Edkins 1999: 11). To conclude, it might be true that participating countries *formally* agreed on a set of recommendations. Consensus, however, was achieved by confining the decision-making process to issues that were relatively safe for the dominant actors.

Apart from the consensual modality of decision-making, there were other mechanisms through which FSF discussions were confined to safe issues. One of those is the very fact that the debate was hosted by the Bank for International Settlements and the Financial Stability Forum. In its statutory objectives, the FSF set itself as a forum for 'national authorities responsible for *financial stability in significant international financial centres*' (FSF 1999a). This not only entails that the FSF is bound to work for leading financial markets, mainly G-7 markets, but also that financial stability in this context assumes a very narrow meaning, which does not include the concerns that small open economies like Hong Kong, Malaysia and Australia manifested vis-à-vis hedge funds. This issue will be more thoroughly dealt with when discussing the role of the structure of meaning (section 1.4).

In conclusion, the two-dimensional view accounts for many aspects of power that the one-dimensional power overlooks: it brings in the idea that issues might be kept out of the decision-making process and extends the analysis to include decisions as well as non-decisions and overt as well as covert conflicts. In addition, the IPE approaches that somehow draw upon the two-

dimensional view go beyond state power and inter-state relations to account for the role of the international institutions in which debates take place. Yet, as Lukes points out, the two-dimensional view of power still displays features of the one-dimensional view that limit its innovative character. First, it is still centred on the existence of a conflict. Without a conflict this approach finds it impossible to assess whether the elite is preventing other interests from being heard and decisions from being taken. This is why a consensual method of decision-making may be misinterpreted as indicative of a pluralist and legitimate governance system, as in Germain's analysis. Second, this view of power is still too committed to methodological individualism, which sees power as exclusively exercised by individuals. The next section argues how these two features limit what can be explained with a two-dimensional view of power.

1.4. Third explanatory model: power of the structure of meaning

Power can be exercised not only by direct conflict, but also by preventing such conflict from arising in the first place – e.g. securing compliance by shaping thoughts and desires (Lukes 1974: 241-242). 'Is it not', Lukes writes, 'the supreme and most insidious exercise of power to prevent people, to whatever degree, from having grievances by shaping their perceptions, cognitions and preferences [...]?' (Lukes 1974: 242). For instance, certain social forces are not aware that decisions that are portrayed as relevant only for a small section of society (e.g. market players) might affect them as well. Moreover, it is difficult to exercise control over highly technical matters when their impact on the real economy is not straightforward. Even when the general impact of a reform is apparent, its true content can be hidden and repackaged as beneficial for society as a whole. All these cases do not necessarily imply a conflictual situation. By insisting on the existence of conflicts, Bachrach and Baratz (two-dimensional view) do not fully exploit their intuition that power is also exercised by creating or reinforcing

social and political values and institutional practices that keep certain issues outside the political agenda (see this chapter, page 47).

Lukes's second criticism of the two-dimensional view of power is that it is still too committed to methodological individualism: power is seen as the result of individuals making conscious decisions between alternatives, 'whereas the bias of the system can be mobilised, recreated and reinforced in ways that are neither consciously chosen nor the intended result of particular individuals' choices' (Lukes 1974: 240). The bias of the system, Lukes continues, [is most importantly sustained] by the socially structured and culturally patterned behaviour of groups, and practices of institutions, which may indeed be manifested by individuals' inaction' (ibid: 240-241). To account for these aspects, Lukes introduces the three-dimensional view of power.

While the one- and two-dimensional perspectives adopt an *individualist* view of power, the three-dimensional perspective represents a shift towards more *structural* concepts of power, where the control over the policy agenda also stems from collective forces and social and economic arrangements. Some scholars argue that Lukes's three-dimensional view does not totally depart from an individualist perspective, as power is still exercised by individuals with structure being the constraint upon them. Power, in other words, is what agents do within the limits of a given structure: where structure ends power starts. For this reason, critics say, it would not be possible to talk about 'structural power' (Layder 1985: 375-378). Yet it is indisputable that the three-dimensional view is a bridge towards structuralist approaches to power.

An increasing share of the IPE literature conceives of power as structural power (Caporaso and Haggard 1989). The previous section quoted Strange arguing that 'in the competitive games now being played out in the world system between states and between economic enterprises it is

increasingly structural power that counts far more than relational power' (Strange 1999 [1988]: 24). Robert Cox even comes to consider IPE as an inherently structural approach. He defines political economy as 'concerned with the historically constituted frameworks or structures within which political and economic activity takes place', while he considers both political science and economics as actor-oriented studies (Cox 1995: 32).

Overall, much of the IPE literature working from a three-dimensional perspective conceives of structural power as something more than a constraint upon action. Strange clearly grants structural power both a constraining and an enabling role when she defines it as 'the power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises and (not least) their scientists and other professional people have to operate' and when she says that 'structural power, [...] confers the power to decide how things shall be done' (Strange 1999 [1988]: 24-25). Similarly Gill stresses the double aspect of structural power as both *incentive and constraint. He writes that, 'structural* power may involve material and normative aspects, such that patterns of *incentives* and constraints are systematically created' (Gill and Law 1988: 73). Cox argues that 'there is a difference [...] between thinking of this actor-structure relationship as a process configuring structural change, and thinking of actions as confined within fixed, given structures in the manner of problem-solving theory' (Cox 1995: 33).

With notable exceptions such as Wallerstein (1999), IPE scholars do not generally conceive of structural power in any deterministic way either. This means that structural power is not thought of in terms of totally compelling structural constraints and objective relations (e.g. relations of production) that make actors the mere bearers of these social and economic structures. On the contrary, 'power is seen as emerging from social processes' (Cox 1996: 225). Cox introduced the concept of 'framework for action' or 'historical structure' as a picture of a particular

configuration of forces. Cox's historical structure is neither a deterministic structure nor the structural constraint upon *actors* of which Lukes talks about, but a context *in* which (and not against which) action takes place. This section argues that a structural power which emerges from social interactions, which shapes the ways of being and doing things and which provides constraints as well as incentives – a framework for action – gives important hints for understanding the regulatory debate on hedge funds.

The sense in which structural power is used in this research is that of the power of the *structure of meaning.* It is argued that hedge funds have been left relatively unaffected because, apart from the interests of the US government and of the transnational financial community in leaving them unregulated, the structure of meaning at the regulatory table shaped interests, perceptions and problems in such a way as to make a more mandatory approach unthinkable. This structure of meaning is defined as the framework within which problems have been brought forward, phrased, and addressed. This framework draws upon the theory of modern finance, which in turn has fostered market practices geared on due diligence and self-assessment of risk.

Two approaches are considered useful to analyse the power of the structure of meaning: the neo-Gramscian perspective in IPE, as embodied in the work of Robert Cox and Stephen Gill, and post-structuralist views in IR centred around the work of Michel Foucault. The next section first analyses the contributions of both approaches – specifically of Cox' concept of historical structure and Foucault's concept of apparatus – and, secondly, outlines the reasons to privilege a post-structuralist approach.

1.4.1 Neo-Gramscian IPE

Lukes's three-dimensional view of power gives great attention to the power of shaping ideas, preferences and thoughts through the control of information, media and the processes of

socialisation (Lukes 1974: 241). This feature of Lukes's analysis is present in the work of Robert Cox and Stephen Gill. It is apparent in Cox's idea of hegemony. Cox defines hegemony

> In the Gramscian meaning of a structure of values and understandings about the nature of order that permeates a whole society [...] [and that] appear to most actors as the natural order of things. They are the intersubjective meanings that constitute the order itself. Such a *structure of meanings* is underpinned by a structure of power, in which most probably one state is dominant but that state's dominance is not sufficient by itself to create hegemony. Hegemony derives from the way of doing and thinking of the dominant social strata of the dominant state or states insofar as these ways of doing and thinking have inspired emulation or acquired the acquiescence of the dominant social strata of other states. These social practices and the ideologies that explain and legitimise them constitute the foundation of the hegemonic order. Hegemony frames thought and thereby circumscribes action (Cox 1996: 517-518).

According to Cox, these structures of meanings or frameworks of thought are created as a response to material conditions (Cox 1995: 34). He writes that, 'ideas have to be understood in relation to material circumstances', which are seen to include 'both the social relations and the physical means of production' (Cox 1983: 168). Gill also points out that 'the normative aspects of structural power need to be linked to more material aspects, aspects which are normally stressed in classical Marxist accounts of the relations between labour and capital' (Gill and Law 1988: 74).

This means that in neo-Gramscian IPE structures of meaning stem from and support the dominant mode of production. The regulatory debate on hedge funds would be but a reflection of the increasing power that financial capital is holding in the world economy. Gill talks of the capacity of financial capital to discipline labour and constrain the state to 'market friendly' policies (Gill and Law 1988: 87). The structural power of internationally mobile capital comes with its own ideas about what an acceptable economic and regulatory policy is. For instance, the interest of internationally mobile capital is to emphasise the crucial role of global financial markets in bringing about a higher level of investment and the consequent necessity of leaving these markets unfettered to allow for an efficient allocation of this investment. Once it becomes

the common objective of those in the position of taking relevant decisions within regulatory agencies, it 'impl[ies] a redefinition of the "limits of the possible"' under the assumption that there are no alternatives to a certain vision of the economy (Gill and Law 1988: 89).

While affirming the importance of structures of meaning in shaping the world economic order, this approach makes them dependent upon an objective and external set of material conditions of existence. These material conditions are seen to precede the political level and to belong to the objective relations of production (De Goede 2002: 90). Following De Goede, this chapter argues that these material conditions are instead articulated and continuously recreated in the discursive construction of reality. An example might clarify the point. Gill points out that the structural power of capital manifests itself in the privileged position that the private business sector enjoys within capitalist society (Gill and Law 1988: 86-87). He takes as an example the fact that governments have to be concerned with the preservation of the 'business climate' or otherwise be exposed to the risk of an investment strikes. A government will be constrained in its ability to pursue an expansionary policy, as in this case it will have to raise taxes to finance the increased spending and the assumption is, as Gill writes, that the supply of capital, enterprise and inventiveness will be reduced by higher taxation (ibid: 87). He continues: 'Indeed such arguments are the essence of so-called 'supply-side' economics which became influential in the USA in the 1980s' (ibid: 87). Gill attributes the privileged status of the private business sector – and financial markets more specifically – to the different position of capital and labour under capitalist conditions, which the supply-side theory only sanctions.

The same situation, however, can be looked at from a different angle. Only a few years before the advent of supply-side economics, it was the primacy of investment over saving that was privileged by the then dominant Keynesian economics. For Keynes, investment creates or mobilises its own saving, so that government spending can be said to be conducive to higher

and not lower levels of saving. For Monetarist economics, it is saving that mobilises investment. In other words, Monetarist and Keynesian theories differ in their understanding of the relationship between 'S' (saving) and 'I' (investment): for the latter S is a function of I (S=S(I)), while for the former I is a function of S (I=I(S)). Since the Monetarist shift in the 1970s, the primacy of saving over investment has been 'disputed only by a handful of old-fashioned Keynesian and post-Keynesians of newer vintage' (Toporowski 2000: 2) and has provided 'the key policy justification for financing and supporting financial markets, modelled on those of the United States, throughout the world' (ibid: 2). More to the point, the primacy of saving over investment has been the precondition for the dominance of finance over the real economy (Toporowski 2000) Were Keynesian ideas still dominant, the rationale for granting privileges to financial markets and the fear of the 'investment strike' would be removed.

This shows that a structure of meaning does not necessarily stem from a particular set of material conditions, but can help to create those conditions in the first place. More generally, any distinction between the material and the ideational can be said to isolate some hard-facts and objective material reality from the realm of political struggle (De Goede 2002: 90). By so doing, it gears empirical research to a fixed, pre-political reality and does not help us consider the many ways in which gains and entitlements are continuously redistributed across different fractions of capital. For instance, the promotion of hedge funds as efficiency-enhancers and the legitimisation of more aggressive speculative strategies throughout the investment community (ideational) contribute to the polarisation of wealth and the redistribution of capital gains from ordinary investors and depositors to more sophisticated investors (material). This makes the Marxist dichotomy capital/labour, seen as the result of objective and fixed relations of production, too limited. Many more dichotomies can be displayed between different fractions of capital, and none of them is fixed and prior to the political. The next section presents the

contribution of Foucault's definition of discourse as apparatus and shows how it can overcome some of these difficulties.

1.4.2 Post-structuralist IPE

Post-structural studies in IR and IPE have mostly drawn upon the work of Michel Foucault. The appeal of Foucault's analysis of power is its departure from the idea that power is exercised by the state as an act of coercion or that it stems from an objective set of economic relations of production. Clearly located within Luke's three-dimensional view, power for Foucault stems – and at the same time informs – truth- and knowledge-production systems. The sovereign power of the state is replaced by other sovereign standpoints or truth claims, so that individuals are subjected to forms of power other than the power traditionally associated with state authority.

Foucault maintains that in the Western world the concept of power has kept a strong link with the system of rights, so that power is conceived in terms of sovereignty (both as 'rights to sovereignty' and 'legal obligation to obey it', Foucault 1980: 95) even outside the domain of the state. As he said, 'in political thought and analysis, we still have not cut off the head of the king' (Foucault 1990 [1978]: 88-89). This conception of sovereignty, whose origins he situated at the time of the formation of the European monarchy, is meant as a standpoint to resolve competing claims by remaining above them and by alleging legitimacy in terms of law and rights. He sees this concept of sovereignty as applied within other contexts, wherever a standpoint is supposed to decide what is 'legitimate' and what instead escapes the definition of right, proper and normal (Foucault 1986). This happens in particular with knowledge and the appeal to the scientific method. By appealing to the scientific method of enquiry, knowledge assumes the role of objective, neutral and general explanation that remains above competing claims. Foucault defines it as 'epistemic sovereignty' and the truth- or knowledge-producing systems as 'discourses' (Foucault 1986; Foucault 1980: 94-95 and 197-199).

It is in this sense that discourse has been interpreted in Economics and in IPE: as an episteme or body of ideas that defines the limits of what is scientifically possible and acceptable at a particular period. Non-mainstream financial economists have used discourse to question the positivism and essentialism of modern finance, that is, its claim to objectivity in explaining the working of the market. Non-mainstream financial economics is herein meant to refer to all those strands in the literature that depart from the project of modern finance (and in general from neoclassical economics) and either draw on different traditions, such as Marxist or Keynesian economics, or bring in insights from other disciplines, such as critical realisms, postmodernism and so on. Reference is especially made to the *Alternative Perspectives on Finance and Accounting Journal* and the *Association for Heterodox Economics.* The former is an online journal that gathers contributions from competing perspectives on accounting and finance. The latter is an association of economists open to trans-disciplinary analysis and deploying approaches neglected by the current orthodoxy. (For more information see their respective websites at http://www.departments.bucknell.edu/management/apfa and www.hetecon.com).

Authors like Elton McGoun and George Frankfurter, who contribute to the *Alternative Perspectives on Finance and Accounting Journal*, have stressed the ideological nature of such theories as the Efficient Market Hypothesis and the Capital Asset Pricing Model (Frankfurter and McGoun 1999; McGoun 2000; McGoun 1992). By using these theories as examples, their aim has been to 'recognise the ubiquity of ideology in finance and admit and understand the values implicit in its neoclassical methodology' (Frankfurter and McGoun 1999: 159). Their main target has been Friedman's positivist methodology, which was illustrated in Section 1.2. The discourse they look at is mainstream academic Finance: its assumptions, methodology and language. They carry out the much-needed task of questioning what is perceived as natural and objective. By so doing, however, they keep discourse at the level of utterances and statements,

and do not exhaust its social and political interconnectedness. Foucault's definition of the *episteme* as that specific apparatus 'which makes possible the separation [...] of what may from what may not be characterised as scientific' (Foucault 1980: 197) accords with this notion of modern finance as discourse.

Similarly, some economists belonging to the *Association for Heterodox Economics* (AHE) have used discourse in a purely textual or linguistic sense, that is, as a device to analyse speeches, texts, interviews, and so on. In 'Techniques for Interrogating Text', Wendy Olsen (Olsen 1999) elaborates a type of discourse analysis in Economics that emphasises coding transcripts and interview answers. Olsen's discourse analysis resembles the linguistic technique of conversation analysis, where a link between the '"micro" structures of conversation and the "macro" structures of social institutions and societies' (Fairclough 1989:12) is rarely made. By so doing, Olsen considers discourse to be unable to exhaust power relations, and somehow recommends the use of other theories to account for the deep structures and material power relations that make discourse possible in the first place (Olsen 1999). This literature inevitably strengthens a concept of discourse as episteme.

International Political Economy has increasingly used discourse. In general, however, it has used it to stress the role of ideas in policy processes. Ideas have often been conceived as independent variables that remain outside the actual exercise of power. A good example is provided by the epistemic community literature. In this literature, ideas have been conceived as autonomous variables that get into the policy process via communication and ideas sharing between experts (Haas 1992, Adler and Haas 1992; Kapstein 1992) and that have most of their influence during period of crisis or uncertainty. Kapstein illustrates the process by which an epistemic community can arise in the period following the outbreak of a crisis and does so by looking at banking regulation in the aftermath of the 1980s debt crisis. Yet Kapstein is reluctant

to call central bankers an epistemic community, given the fact that their decisions were not 'solely the product of rigorous scientific investigation [but also] [...] reflected a political decision' (Kapstein 1992: 267). The separation between an 'ideational shield' (ibid) and the material working of the market reinforces a concept of financial discourse as episteme only.

By different means, these contributions to the study of discourse say that it is impossible to account for power relations in the international political economy by recourse to the concept of discourse *alone* and that discourse has to be used jointly with other theoretical explanations (material conditions, etc.). Thrift and Lyshon perfectly express this feeling when they write:

> '[W]hat I cannot accept is that discourse is exhaustive of reality, or that there are no relationships of necessary dependence between what is sayable at any time and the ways the world happens to be materially organised' (Sober cited in Leyshon and Thrift 1997).

Other authors make the same argument. Pauline Rosenau, for instance, argues that while discourse with its post-structuralist underpinning helps 'ask some of the most potent questions we are capable of phrasing' (Rousenau 1992: 169), discourse alone is not enough (ibid: 12). This view has contributed to the perpetuation of an image of discourse as episteme and to weaken its applicability/theoretical significance: you can use discourse, but you *cannot* use discourse *alone* (Thrift and Leyshon 1997: 3; Rosenau 1992: 12).

This insistence on discourse as episteme may come from a partial reading of Foucault's writings. Foucault introduced two different definitions of discourse, a first one in the *Order of Things* (1970) [1966] and in *The Archaeology of Knowledge* (1972) and a second one in later writings such as *Discipline and Punish* (1991) [1977] and *The History of Sexuality* (1990) [1978]. In the *Archaeology of Knowledge*, Foucault is concerned with what he calls 'rules of formation', which 'are the conditions of existence in a given discursive division' (Foucault 1972: 38). In other words, they are the rules that govern the discursive practices that in turn

structure discourse (Foucault 1972: 31-63). In the case of the discourse of modern finance, this would mean analysing the rules of formation and their organisation in discursive practices that shape the very object that modern finance talks about: e.g. the way of measuring financial phenomena, of separating financial economics from other fields of inquiry, of drawing limits to what is of concern to finance and what is not, and so on. In the *Archaeology of Knowledge*, therefore, discourses are treated as autonomous systems of scientific knowledge – or systems of scientific statements – structured according to historically specific formation rules (discourse as *episteme*).

In *Discipline and Punish* and the *History of Sexuality* Foucault instead defines discourses as systems of power/knowledge relations, 'where power and knowledge directly imply one another... [and] there is no power relation without the correlative constitution of a field of knowledge, nor any knowledge that does not presuppose and constitute at the same time power relations' (Foucault 1991 [1977]: 27). Discourse and power are related in the sense that 'discourse can be both an instrument and an effect of power' (Foucault 1990 [1978]: 100-101; see also Howarth 2000: 77-78). Foucault calls this different conception of discourse a *dispositif* or *apparatus* (instead of an episteme), which is 'a thoroughly heterogeneous ensemble consisting of discourses, institutions, architectural forms, regulatory decisions, laws, administrative reforms, scientific statements, philosophical, moral and philanthropic propositions – in short, the said as much as the unsaid. [...] The apparatus itself is the system of relations that can be established between these elements' (Foucault 1980: 194). In this way discourse includes both discursive and non-discursive elements (such as the political strategies, institutions, arrangements and in general the disciplinary technologies he talks about in the *History of Sexuality*). Foucault explains this shift is his understanding of discourse in these terms:

> The apparatus is [...] always inscribed in a play of power, but it is also always linked to certain coordinates of knowledge which issue from it but, to an equal degree, condition it. This is what the apparatus consists in: strategies of relations of forces supporting, and supported by, types of knowledge. In seeking in *The Order of Things* to write a history of the *episteme*, I was still caught in an impasse. What I should like to do now is to try and show that what I call an apparatus is a much more general case of the *episteme*; or rather, that the *episteme* is a specifically *discursive* apparatus, whereas the apparatus in its general form is both discursive and non-discursive, its elements being much more heterogeneous (Foucault 1980: 196-197).

Problems have been variously voiced about his definition of the 'non-discursive', as in principle in his theory any object or ensemble is always a signifying one and, therefore, a discursive one. Foucault responded first by equating the non-discursive with the term *institution* – 'all the field of the non-discursive social is an institution' (Foucault 1980: 198) – and then eventually by saying that 'it doesn't much matter for my notion of the apparatus to be able to say that this is discursive and that isn't' (ibid), as long as both are linked together by the discourse as apparatus (ibid: 194). By so doing, Foucault affirms the materiality of discourse both in terms of its reproduction and its effects of power. Discourses do not only indicate what is scientifically acceptable, but also permeate the non-discursive elements of society that have to foster and reproduce that vision of the world. By affirming the materiality of discourse, Foucault asserts that discourse 'cannot be reduced to more primary processes, such as economic production, social institutions or political behaviour' (Howarth 2000: 81). This distances Foucault's concept of apparatus from the conceptualisation of discourse in neo-Gramscian IPE and assigns it a more autonomous role in the analysis of power.

Another important point that is captured by the above quotation is that the 'said' in a discourse is as important as the 'unsaid' or, more precisely, that both are part of the apparatus. This provides a powerful answer to Lukes's two-dimensional view of power. As much as Lukes is concerned with non-decisions and what is *intentionally* kept outside the political agenda, Foucault is concerned with what discourse does not say or prevents from being said. The

concept of apparatus, however, goes beyond the two-dimensional view of power. Lukes's two-dimensional power explores what is kept outside the political agenda because of an inherent conflict between dominant and subordinate interests. Nondecision-making is defined as 'a means by which demands for change in the existing allocation of benefits and privileges in the community can be suffocated before they are even voiced; or kept covert; or killed before they gain access to the relevant decision-making arena; or, failing all these things, maimed or destroyed in the decision-implementing stage of the policy process' (Bacharatz and Baratz cited in Lukes 1974: 239).

According to Foucault's concept of apparatus, certain issues are kept outside the policy agenda without a deliberate struggle. Structures of meaning determine what gets framed as a problem to begin with. Battles are not only 'at the level of wanting or resisting a particular policy initiative, but at the level of constituting the shape of the issue to be considered' (Bacchi 1999: 50). Instead of looking solely at what is kept outside the policy-making or regulatory table – as the two-dimensional power does – a discourse approach reflects upon the fact that only certain grievances can be formulated and only certain problems can be thought of. In other words, problems and grievances are considered as such only when they have become part of a discourse (ibid: 49).

By referring to the definition of apparatus, the discourse of hedge funds will be explored by: (1) pointing out the material and not only mental character of discourse; and (2) identifying the elements that inform this discourse both as systems of meaning and of social and economic relations. The various elements that keep the discourse together will be analysed in Chapter 3 and 5. These elements relate to the theory of modern finance and more generally to the dominant economic understanding of the market. According to the definition of discourse as apparatus, these elements will be traced in financial ideas as well as in institutions, regulatory

mechanisms, administrative and political decision-making processes, and in what the discourse does not say. They will also be linked to the strategies of power – e.g. the interests – that support and are supported by this type of knowledge.

A way to apply this theoretical schema to empirical analysis is to look at how problems are framed and questions are raised in a decision-making setting and which interest this mode of problematization promotes. This means 'drawing attention to the ways in which [...] policy problems get 'created' in discourse' (Bacchi 1999: 48). According to Bacchi,

> 'It is inappropriate to see governments as responding to "problems" that exist "out there" in the community. Rather "problems" are "created" or "given shape" in the very policy proposals that are offered as "responses"' (ibid: 48).

This means that not only solutions but also problems are created in the process of targeting them. Some scholars call this approach a *policy-as-discourse* approach (see for instance Bacchi 1999). Paraphrasing them, a *regulation-as-discourse* approach draws attention to the ways in which regulatory problems and solutions are created. This is in line with Foucault's theory, according to which the focus should be on problematization rather than on problems (Foucault 1992 [1984]: 10-11). So, by looking at the questions raised in the debate on hedge funds, it will be possible to understand why certain issues made it to the regulatory agenda while others did not.

Michael Shapiro followed a similar method of enquiry in his analysis of public policy in Los Angeles. The following abstract from his study is most indicative of a policy-as-discourse analysis:

> The writers [of dominant accounts] recognise that Los Angeles has "problems", but the grammar of their policy discourse is the familiar one, a political science discourse that offers a mythic unified actor, a set of decision makers who strive to cope with traffic, pollution, and political integration. There is no narrative on the production of the problems (or the production of nonproblems) other than what is implied in the concept of "growth". It is thus the typical passive grammar of decision makers "faced

> with problems" rather than, for example, a more politically acute version that would inquire into the way public policy thinking tends to remain within certain narrow modes of problematization. For example, "traffic congestion", which receives more space than any other urban problem, is a middle-class problem, in that it accepts the already-produced segregation, housing, and shaping of the labour force that has arisen from the structures of real estate speculation, work force creation, city planning, and so on. Traffic congestion is a "complaint" from those who are in a position to vocalise: it does not access the production and distribution of such position (Shapiro 1992: 99-100).

Chapter 5 makes a similar argument about the problem of financial systemic stability: here the word 'systemic' conceals the fact that stability is mainly defined as a G-7 problem. The discourse of financial stability then takes shape in the creation of the Financial Stability Forum and its working groups, which accounts for the materiality of discourse. Problematising this discourse helps explain why hedge funds have been analysed through a very narrow focus. For instance, the role of hedge funds in disrupting market integrity in emerging markets has been less targeted than their role in affecting systemic stability in major financial centres. In the same way, the role of short selling in accelerating economic downturns and its impact on worsening income inequalities have not only been kept outside the regulatory agenda, but even failed to emerge as a concern (they remained at the level of the un-said). From this point of view, the present study is a contribution to the kind of questions that *ought to* be raised in discussing the reform of the Global financial architecture in order to move beyond the current emphasis on financial stability.

1.5 Conclusion

This chapter has developed a theoretical framework to explain the outcome of the regulatory debate on hedge funds. Three main explanations have been taken into account and each of them has been examined for the interest they promote and the policy options they lead to.

The first explanation draws upon mainstream economic theories of financial markets and says that the empirical evidence on hedge funds did not point to the need for their regulation. Section 1.2 has shown how the empirical evidence that this account refers to is not as objective as its proponents argue but supports a precise political position in favour of the most sophisticated financial players.

Against this economic account, the second and third explanations develop a political economy approach. They do so by drawing upon Lukes's three dimensions of power. The second explanation says that the outcome of the debate is a consequence of the distribution of power at the regulatory table. Considering that the Working Group on hedge funds was made up of representatives of G-7 countries plus Australia and Hong Kong, this explanation focuses upon the relative power of participating actors and concludes that the US government dominated the agenda. In a second instance, the role of the institutional setting where the debate took place is introduced and considerations are made on how it helped certain actors (US government) and interests (transnational financial community) to prevail.

The third explanation says that the power of shaping the debate on hedge funds went beyond the actors at the regulatory table and the institutions superseding the process. Hedge funds remained unregulated because the structure of meaning within which discussions took place and problems were framed directed the decision-making process towards this outcome. This structure of meaning was identified with the whole theoretical apparatus that revolves around modern finance and the market and regulatory practices that emerged from it. This account says that even without the clear dominance of a group of actors, the range of feasible solutions would be limited to what this structure or discourse says.

This chapter has outlined the theoretical justification for each of these explanations and prepared the ground for the analysis in the following chapters. Chapters 2 through 6 bring empirical evidence to support or discard these three accounts and also point out their policy implications, which this chapter has only briefly dealt with in its introduction.

CHAPTER 2

THE HEDGE FUND INDUSTRY:

Theory, Practice and History

2.1 Introduction

This chapter provides an overview of the theory and practice of hedge funds and of the major market episodes in which they played a role. It draws on the economic and financial literature, both academic and industry-driven. On the one hand, it reproduces the kind of account on hedge funds that prevails in Business Schools and Finance departments. On the other hand, it allows us to assess the claim of the first explanatory model, according to which hedge funds have been left unregulated because the empirical evidence did not point to the need to change their regulatory regime.

But does the empirical evidence (number, performance, strategies, etc.) point so neatly towards the harmless nature of hedge fund practices? Is it not the actual theorisation of hedge funds by practitioners and economists, rather than the empirical evidence, which has conveyed the idea that hedge funds are not a problem but a positive aspect of the market? This analysis prepares the ground for Chapter 3, which specifically challenges the representation of hedge funds that came out of mainstream economic accounts and the interests it promotes.

This chapter is split into two main parts. The first considers the theory and practice of hedge funds and is divided into six sections, which deal with: (1) the definition of hedge funds, (2) their origin and investment philosophy, (3) the regulatory/legal regime they are subject to in the US, (4) the strategies they pursue; (5) their number and capital under management, and (6) their

performance and risk-return profile. The second part deals with the history of hedge funds from their launch in 1949 to the beginning of the 21st century and is split into six further sections: (7) the beginning of hedge fund investing; (8) the ERM currency crisis of 1992 and the Asian currency crises of 1997 and 1998; (9) the near-collapse of LTCM and the emerging market turmoil of 1998; (10) the Internet bubble; (11) the speculative activities following September 11; and (12) the case of vulture funds.

As hedge funds were brought into the political debate on currency crises and financial speculation only in the 1990s, the emphasis will be on the events of the last decade. The first two events – the Asian crises and LTCM – are the ones that led to the regulatory debate on hedge funds. Hedge funds' involvement in the Internet bubble, post-September 11 and vulture investing have not been acknowledged in either the FSF debate or more general discussions on the Global Financial Architecture.

PART ONE

2.2 Definitional issues

There is no straightforward definition of the term 'hedge fund'. Academics, practitioners and regulators point to the difficulty of combining in a single definition a range of funds that pursue different strategies, in different markets and with different levels of capital and risk (Cummings, interview 2002).[7] There is, however, a common organisational structure and legal regime that unite seemingly different vehicles. It is this common structure and regime that the name hedge fund refers to.

[7] Christopher W. Cummings, Office of the Chief Counsel, Division of Trading and Markets, Commodity Futures Trading Commission.

The literature on hedge funds defines them as collective or pooled investment vehicles that (1) are organised as private partnerships (limited partnerships or limited liability companies) collecting money from high-net-worth individuals and institutional investors; (2) are administered by professional investment managers; (3) are not widely available to the public; (4) operate largely outside any regulatory requirement; (5) are often resident offshore for tax and regulatory purposes; (6) have maximum flexibility in their investment strategies; and (7) have their managers, who usually keep part of their own capital invested in the fund, paid on a fee-for-performance basis (IMF 1998: 2,3; PWG 1999: 1; FSF 2000: 80; Deutsche Bundesbank 1999: 31; Eichengreen 1999: 415; Caldwell 1995: 2; Lederman 2001: 3; FSA 2002: 8).

The six following sections examine those features in detail. Section 2.3 looks at the origins of the practice, which also helps explain the particular choice of name. Section 2.4 shows that hedge funds exist because of a gap in the US securities and investment company regulations and it introduces the main exemptions hedge funds can benefit from. Section 2.5 analyses hedge fund investment strategies and the distinguished character of each of them. Section 2.6 analyses whether hedge fund strategies are stabilising or destabilising. Section 2.7 provides statistics on their number and capital under management both in absolute terms and by geographical location. Section 2.8 analyses the performance of hedge funds and in particular whether they systematically outperform traditional asset classes.

Before moving to section 2.3, a caveat is important. Hedge funds were born as a US phenomenon in the 1950s and until the mid/late 1990s most if not all of them were managed from the US. It is unavoidable, therefore, that the analysis of their origins, history and organisational structure is generally focused upon the US industry.

2.3 Inception

The name 'hedge fund' can be misleading. Hedging means covering open positions, that is, covering or controlling risk. Hedge funds, however, do not always hedge and the reason why they became popular after the emerging market turmoil of 1998 is not their low-risk character. To understand the origin of the name, it is necessary to go back to their beginnings and to what their inventor had in mind. Their invention is unanimously attributed to Alfred Winslow Jones, a sociologist and financial journalist who in 1949 in the US created the first such vehicle. His purpose was to take two investment strategies that are commonly understood to be speculative – short selling and leverage – and combine them to create a conservative investment system (Caldwell 1995: 7). Conservative, in this context, refers to a system that is better able to cope with risk.

Short selling is the practice of 'selling a borrowed asset on the expectation that its price will decline by the time of repayment' (Chada and Jansen 1998: 27). For example, a trader borrows stocks to sell them in two months time (forward sale), betting that by that time their price would have dropped. At the end of the two months, the trader buys the stocks to return them to the lender and, if the price effectively dropped, he or she would gain all the difference between the selling and the buying price. Leverage instead refers to the use of debt to acquire assets and thus raising the expected return per unit of capital employed (Deutsche Bundesbank 1999: 30). In the usual definition leverage is measured in terms of ratio of assets to capital (De Brouwer 2001: 10). This is called *on-balance-sheet leverage*, as assets, capital and debt are all balance sheet items. This is the definition generally used by data providers. Another definition measures the leverage arising from off-balance-sheet transactions, such as short positions, repurchase agreements, and derivatives contracts (short selling, in this definition, becomes an instrument of leverage too). This is called *economic leverage* and, contrary to the on-balance-sheet version, no comprehensive information on hedge funds' economic leverage is available (ibid).

Going back to Jones's model, how was it possible to obtain a conservative system out of short selling and leverage? In order to answer this question, it is necessary to look at the idea of risk behind Jones's strategy. The case of equity investment will be considered. Risk in equity investment is commonly understood as the sum of two different risks: (1) general market risk and (2) risk linked to the particular stock selection. Market risk refers to the fact that an equity investment can lose value because of a general market drop. Stock-selection risk, instead, means that an equity portfolio can be affected by a drop in the price of the selected stocks. Jones thought that if it were possible to design a strategy to minimise market risk and at the same time maximise stock risk, this would place all the risk in the hands of the manager and his ability to pick the right stock, while the impact of overall market trends would be neutralised. He calculated his exposure to market risk using the following formula:

$$\text{Market exposure} = \frac{\text{(Long exposure – Short exposure)}}{\text{Capital}}$$

According to this formula, market risk would be completely neutralised if the value of the shares Jones bought were equal to the value of the shares he sold short. In this extreme case, the above equation would be zero - hence market risk would be zero. Usually, the portfolio was not left completely hedged but partially exposed to market risk. In the formula shown above, long exposure would usually be higher than short exposure, following the reasoning that the market generally rises. In this case, the portfolio would be 'net long' (Caldwell 19995: 7).[8]

Having hedged market risk, return would mainly depend on the ability of the manager to pick the right stocks. How was it supposed to happen? Jones's strategy was to go long on (buy) shares that he considered 'undervalued' and go short on (sell) shares that he considered

'overvalued'. The better the choice of the stocks, the higher the returns and the lower the risk. This because in a rising market good long selections (undervalued stocks) would rise more than the market and good short selections (overvalued stocks) would rise less than the market, thus amplifying the return to the fund. The reverse would happen in a falling market, where undervalued stocks would fall less and overvalued stocks would fall more, again amplifying the exposure and return to the fund (ibid: 8). In other words, return and risk were made dependent on the capacity of the manager to pick the most undervalued stocks and sell the most overvalued ones.

Having controlled market risk, Jones would also be 'liberated to amplify stock picking skills with leverage' (Caldwell 1995: 7). In the classic example provided by Caldwell, the manager has an initial capital of $1000 and employs leverage to buy shares valued at $1,100 and sell short shares valued at $400. The gross investment is $1,500 (150 percent of initial capital) and the net market exposure is $700 (net long exposure in this case). Of the $1,500 gross investment, $700 is unhedged and exposed to both market and stock selection risk. The other $800 is hedged ($400 long and $400 short) and is only exposed to stock risk. If the market rises, the fund would profit from its long net exposure ($800) as well as from the fact that good long pickings grow more than the market and good short pickings grow less than the market. If the market falls, the fund would lose as much as the market in its long net exposure, but it would lose less than the market in its hedged positions (good long pickings fall less than the market and good short pickings fall more than the market). The portfolio is therefore structured to provide *superior* performance, which means performance that is superior to that of the market (mainly measured by market indices) at lower risk of loss. This is an important point that has endured throughout the years and is emphasised in any account of hedge fund strategies: hedge funds are expected to make profit in all market circumstances, even (and particularly) when

[8] Of course, the portfolio can also be net short.

market indices fall (Stonham 1999a: 285). This is also perceived as the main difference between hedge funds and traditional long-only portfolios of mutual funds.

In the vocabulary of Modern Portfolio Theory (MPT) – the theory formulated in the early 1950s at the University of Chicago and still considered the milestone of modern finance (see Chapter 3) – market risk has come to be identified as *beta* and the risk from stock selection as *alpha.* MPT, however, has solved the relationship between risk and returns in a diametrically opposed way. For MPT it is the risk specific to stock selection (alpha) that can be reduced or eliminated by diversifying the portfolio, while all the return comes from bearing market risk (beta), which cannot be eliminated. According to this theory, investment managers can but follow the market and cannot expect rates of return higher than market rates. If they are risk-averse, they can build a portfolio whose overall risk (intended as volatility of returns) is lower than the market's, but in this case they have to expect lower returns; if they are risk-lover, they build a portfolio whose risk/volatility is higher than the market's and in this case they can expect higher returns. Jones's reasoning ran contrary to this: he believed that risk could be eliminated *without reducing returns*, but by *actively* managing alpha.

Since then, this theoretical difference has defined the borderline between hedge funds and traditional investment managers (e.g. mutual funds). Hedge funds have come to identify a 'dynamic' or 'active' management compared to the passive management of mutual funds, which are said to passively follow the market (e.g. matching the performance of some market index). It has also contributed to an image of hedge funds as skilled investment vehicles, where all the return depends upon the stock-picking ability of the manager.

Three other features of Jones's model were supposed to foster the skill-based character of the fund: first, the manager receives performance-based fees (also called *incentive fees*); second, the

manager keeps all or a good part of the capital invested in the fund he manages; third, a slim decision-making structure helps the manager respond quickly to new market opportunities. With regards to the fee structure, in Jones's model the general partner takes 20 per cent of the fund's profits and a fixed management fee of 1 percent of capital under management.[9] This is in contrast with the mutual fund industry, where managers are remunerated on the basis of a fixed percentage of the assets under management. Twenty percent is a huge slice of profits, which is supposed to attract top-calibre people and place a premium on the stock-picking skills of the manager. Reportedly it is one of the reasons why many talented individuals since the early 1990s have defected proprietary trading desks in prestigious banks and institutional money management departments to start their own hedge funds (Lederman 2001: 2). Yet, this incentive could also trigger moral hazard considerations, as the manager might be pressured to pursue excessively risky investment strategies in order to get higher absolute returns for the fund and hence higher incentive fees for herself/himself. This aspect is mitigated by the requirement that the manager holds a good share of his capital in the fund: Jones reportedly kept all of his investment capital in the fund and this rule has been maintained unaltered until today (IMF 1998: 34; Caldwell 1995: 8; Deutsche Bundesbank 1999: 31). Finally, the decision-making process is particularly slim, with not many lines of authority, which could hinder the stock-picking ability of the managers by imposing limits on his/her flexibility. Decisions are almost totally concentrated in the hands of the general partner and the portfolio managers: this facilitates quick decisions about investment and disinvestments and ensures that the fund moves faster in and out of positions.

The whole structure of Jones's model, including its notion of risk, was built around the idea of the skilful individual manager, who needs strong incentives to produce superior returns and beat

[9] The rest of the profits/losses are allocated to all limited partners in proportion to their ownership. They are called 'pooled investment vehicles' as the capital of all partners is pooled together for the purpose of

the market. Most sources on this subject emphasise this aspect of the investment behaviour of the manager (Hills 1996; Caldwell 1995). Caldwell, for instance, who is the most authoritative source on the history of hedge fund strategies, says that the three key variables for hedge fund performance are motivation, opportunity and compass. Caldwell writes: 'The *motivational dynamics* of Alfred Jones's original hedge fund model run straight to the core of capitalistic instinct in managers and investors. The critical motives for a manager are high incentives for superior performance, coupled with significant personal risk of loss' (Caldwell, 1995: 13, my italics). As for *compass*, Caldwell writes: 'We use the word compass [...] as a noun to embody the intrinsic qualities that guide *superior* capitalists' (Caldwell 1995: 16, my italics).

The motivational structure that Jones created in 1949, coupled with the fact that hedge funds are almost totally unregulated, makes hedge funds the purest example of the 'capitalist instinct' of investors and managers. In addition, the fact that hedge funds operate outside any regulatory net (see next section) means they can act in a situation similar to that of perfect free markets, which are the ones economists are used to model. Hedge funds, therefore, became the symbol of the unfolding of pure market forces.

2.4 Regulatory regime

If there is no commonly accepted definition of hedge funds among practitioners, no mention is to be found in the US federal or state securities laws, which means that *regulators in the US do not legally define the term hedge fund.* They do, though, provide exemptions from securities and investment company laws for investment vehicles that abide by certain rules of size, public offering and class of investors. In the US the laws that accord hedge funds exemptions are the

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trading in securities or related assets.

Securities Act of 1933, the *Securities Exchange Act of 1934*, the *Investment Company Act of 1940*, the *Investment Advisers Act of 1940* and the *Commodity Exchange Act of 1974.*

In order to avoid regulation, a fund must fulfil the following conditions: (1) it does not have more than 100 investors and 'is not making and does not presently propose to make a public offering of its securities' (§ 3(c)(1) 1940 Act);[10] and (2) each investor in the fund invests at least $1 million.

In 1996, the US Congress made a further exemption with regards to point (1). According to the new § 3 (c) (7), a fund is exempted from regulation if it does not make a public offering and *only has qualified purchasers.* Therefore, a fund can have more than 100 investors, but they all have to be qualified ones (in addition to qualified purchasers, the fund can have no more than 100 non-qualified investors, as previously established). A qualified purchaser is 'any natural person [...] who owns not less than $5,000,000 in investments; [...] any person acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments (§ 2 (a) (51) Investment Company Act, 1996 revision).

These exemptions discriminate between those funds that will be required to register with the SEC and those that will not need to. But what does the SEC registration imply? According to § 12 (a) of the Investment Company Act, '*it shall be unlawful for any registered company*, in contravention of such rules and regulations or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors [...] *to purchase any security on margin [and] to effect a short sale of any security'* (my italics). In other words,

registration with the SEC implies that a fund will be forbidden to use strategies that increase leverage (e.g. short selling, buying on margin).

This provision stems from the SEC mandate to protect investors and especially those investing in mutual and pension funds (small investors). Short sale was considered particularly risky and speculative and was thus forbidden for all those funds collecting money from the broader public of investors and depositors. It was not forbidden, however, if the fund collected money from high-net-worth individuals and institutional investors, as they were considered sophisticated enough to take care of their capital and hence in no need of investor protection. This is the rationale behind the non-regulation of hedge funds in the US. As Charles Adams (IMF representative at the FSF Working Group on HLIs) pointed out, 'hedge funds are animals of regulation'. This means that they take advantage of a hole in the US securities and investment company regulation (Adams, interview 2003).

In addition to SEC regulation, hedge funds that act as Commodity Pool Operators (CPOs) and Commodity Trading Advisers (CTAs) are subject to the regulation of the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act of 1974. This regulation concerns those hedge funds investing in or trading commodities, including derivatives, with the exception of swaps and forwards. (The text of the Act talks of 'any commodity for future delivery or commodity option'.)

The CFTC regulation consists of certain registration, disclosure and reporting requirements. To begin with, CPOs and CTAs have to register with the CFTC and pass a proficiency test. The registration procedure is administered by the National Futures Association (NFA), which is the

[10] A non-public offering is also regulated under section 4(2) of the 1933 Securities Act or Regulation D 50 (c) 505, 1933 Securities Act and Regulation D Federal Reserve for the margin requirements on

commodity self-regulatory organisation (SRO) designed by the CFTC. Second, they have to file specific disclosure documents with the CFTC and make them available to prospective participants in the pool. These documents include past performance, any conflicts of interest or legal proceedings against the CPO or CTA. Plus, the CPO has to provide periodic account statements and certified annual reports. Finally, CPOs and CTAs have to maintain books for inspection by the CFTC and the NFA (Cullen-Parry 2001: 51; IMF 1998: 65). There are exemptions hedge funds can benefit from in case: (1) of sophistication of participants in the pool, defined as qualified eligible participants (QEPs),[11] and/or magnitude of the entering capital; (2) pools already fall under the Securities Act of 1933 or an exemption from it; (3) pools are mainly involved in trading securities; (4) the CPO does not advertise the commodity pool; and (5) the commodity pool has 15 or fewer participants and its aggregate gross capital contribution is less than $200,000. Exemptions are less general than those provided for investment companies (see this chapter, page 7-8).

Yet it has to be remembered that this regulation only applies to funds operated in commodity and exchange traded futures markets and this leaves out not only securities but also over-the-counter markets. Furthermore, offshore funds that do not trade with US participants, are not managed by US persons and are not marketed in the US do not need to register with the CFTC (IMF 1998: 65-66). Chapters 4 and 5 will show in more detail that the regulation of CPOs and CTAs is not very thorough and that various reforms proposed in Basel and Washington to strengthen this regulation were not implemented in the end. It can be concluded that hedge funds remain largely unregulated both under the SEC and CFTC jurisdiction.

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brokers/dealers.

[11] Qualified eligible participants are classified as: (1) registered commodity and securities professionals; (2) accredited investors as defined in the Securities Act (see above) with investment in securities and

2.5 Hedge funds' investment strategies

The previous section showed how hedge funds have very few restrictions in the way they carry out their transactions and manage their portfolio and how their managers are free to use short sales, derivatives and leverage to raise returns and cushion risk (IMF 1998: 3). But which strategies do they pursue exactly? In which way do current funds resemble Jones's model?

Hedge funds are portrayed as carrying out a large variety of investment strategies. As they enjoy a high degree of freedom in their prospectus, *in theory there is no limit to the types of strategies* they can undertake (Kodres 1998: 42). Each data provider has its own classification and sometimes differences are a question of splitting the same strategy into distinct categories according to the geographical focus or the situation in which the strategy is used. Hedge Fund Research reports 37 different categories (HFR 2003); the Hedge Fund Association distinguishes 14 distinct strategies (HFA/Magnum Group of Funds 2003), Van Hedge Advisers report 15 different styles (VHA 2003) and Gross 11 (Gross 1995: 88-89). Diversification also seems on the increase: HFR talked of 15 strategies in 1994, 28 in 1997 and 37 in 2003. Appendix 1 makes a list of hedge fund investment strategies by drawing upon the contributions of different data providers.

The one feature that all these strategies have in common is that very few of them consist of a traditional buy-and-hold approach. In one way or another they all try to actively play the market and to be significantly uncorrelated with market results (Calwell 1995: 89). Many of these strategies can be reduced to two main categories (Kodres 1998: 42-54): arbitrage/market neutral funds and macro funds. These two classes of funds are also the ones that most attracted public and regulatory attention from the early 1990s.

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derivatives of $ 2,000,000; and (3) business entities in which all owners/participants are QEPs (IMF paper: 65).

2.5.1 Arbitrage-type hedge funds

This strategy is the closest one to Jones's original model. It aims at profiting from current price discrepancies in two instruments that will have at maturity the same value, and more generally from mis-pricing or mis-valuation between instruments that are supposed to have the same characteristics or be driven by the same underlying factors. In order to profit from these discrepancies, an arbitrage fund always enters into two transactions: it buys instruments that it considers 'undervalued' and sells those it considers 'overvalued'. The fund will use some analytical model to apply to various instruments in order to detect possible discrepancies. LTCM is the most famous example in this category. Its analytical model was formulated by two Nobel prize-winners and gained immediate credibility. The LTCM case is discussed in Section 2.8.

Strategies that can be included in this category are: convertible arbitrage, equity hedge, equity market neutral, equity statistical arbitrage, fixed income arbitrage, merger arbitrage, relative value arbitrage, and short selling (see Appendix 1). In the case of convertible arbitrage, for instance, the manager buys convertible securities (in general convertible bonds, e.g. bonds that can be converted to equity) and sells short the underlying equity, in order to profit from the supposed mispricing of the equity component of the convertible bond relative to traded equity (Kodres 1998: 43). Equity hedge or long/short strategy, instead combines a long position in stocks that are expected to outperform the market and a short position in stocks that are expected to underperform the market – or, alternatively, a short position in the equity index futures.

The reason why these funds are also called 'market neutral' is because they claim that their trades have low or no correlation to market direction and that by holding long and short

positions in similar assets they neutralise market risk (as in Jones's model). There are two things to be considered in relation to this supposed lack of correlation to the market. First, arbitrage funds rely on their analytical model to find and calculate discrepancies in securities prices. They can test ('stress-test') the model and the strategy under different scenarios, but there will always be something that remains unaccounted for and non-forecastable, as the case of LTCM confirms. LTCM did indeed end up having a high correlation to what happened in the market in 1998. Second, the idea behind arbitrage/market neutral funds is that by holding short and long positions of opposite sign market risk is neutralised: this presumes that there is such a thing as two positions that are perfectly symmetrical. The next chapter will provide a clear example of the difficulty of finding assets that, although perfectly identical, trade at different prices (which is what a market-neutral fund looks for).

An important consequence of this idea of market neutrality is that arbitrage funds are allowed to assume higher levels of leverage. They exploit the idea of using offsetting positions (hedging) to obtain financing at lower cost. Margins are in fact lower for positions that entail lower risk and offsetting positions are considered less risky. Banks will be more willing to give them credit and thus their leverage will be higher than that of other funds (Kodres 1998: 46).

2.5.2 Macro funds

Macro funds differ from arbitrage funds in one main respect: they usually do not take offsetting positions, but make directional bets over expected changes in overall economic conditions (e.g. of a country or group of countries). While arbitrage funds attempt to detect and profit from price discrepancies, macro funds attempt to determine whether the price is in tune with the macroeconomic situation to start with (Kodres 1998: 47-49). Macro funds are said to take an opportunistic or 'top-down' approach: they attempt to profit from macro-economic imbalances or changes in economic policy that are likely to affect interest rates, exchange rates, bond/equity

markets or commodity prices. Strategies that can be included in this category are principally macro funds, global macro funds and emerging market funds (Appendix 1).

In currency markets, for example, macro funds look at peg mechanisms to see whether they are credible and sustainable. They examine whether the underlying macroeconomic fundamentals are consistent with the exchange rate as it is currently set. As part of this analysis, they also look at the safety and soundness of the banking sector and, in particular, at the chances that the country in question has to defend its currency. If they decide that the currency peg is unsustainable, they will short the currency, which means selling the currency forward in the expectation of its devaluation. They can use different instruments to do so: they can either borrow the currency in the swap market and then sell it in the spot market or use the forward market (see De Brower 2001: 24 for the use of the swap/spot markets and Lall 1997: and Kodres 1998: 49 for the use of the forward market). In both cases, if the currency depreciates before the expiration of the swap or forward contract, the fund will buy the currency in the spot market at a lower price and sell it at the agreed (higher) price in the swap or forward market (De Brower: 23-24). A third choice, usually in combination with one of the previous strategies, is to buy put options, which are the economic equivalent of selling a currency short. A put option gives the buyer the right to sell the currency at a fixed price during the period leading up to the expiration of the option.

Macro funds trade in these markets through financial intermediaries, usually banks. The bank lends currency to the macro fund or enters into forward contracts: before doing it, the bank asks the fund to put up a certain amount of collateral. The bank has a great power here: it can require stricter collateral agreements and ask for a daily revision of the positions and/or daily liquidation of losses. It is now accepted (see section 2.9) that these strategies were used to short the Thai baht in 1997. Macro funds shorted the Thai baht through the swap/spot market, the

forward market and put options. Collateral requirements in those instances were pretty relaxed, as banks did not rightly price the volatility of the baht (Kodres 1998: 49; Lall 1997).

As much as arbitrage funds have their own analytical models to detect price discrepancies, macro funds have their own system to assess imbalances in an economic situation: they look at the macroeconomic scenario (fundamentals); they assess the soundness of the banking and financial markets system; and they analyse political risk, mainly intended as the risk of not being able to withdraw from the market. They are also said to combine this assessment with an analysis of changes in '*market psychology*'. Macro funds have even been attributed the power to move or 'direct' market psychology. This idea came to prominence at the time of the Asian financial crisis and the attack on the Hong Kong dollar, when macro hedge funds were said to lead the market and induce other people to follow, that is, to trigger herding behaviour (Sachs 1997).

In terms of leverage, macro funds are considered among the highest-levered hedge funds, though not as highly levered as arbitrage funds. The FSF estimates that macro funds' on-balance sheet leverage may range between 3:1 and 4:1 (FSF 2000: 153). When adding economic leverage, overall leverage can go up to 10:1 or 15:1. Moreover, as said before, economic leverage will always be a function of the amount of collaterals that banks ask hedge funds to post: the lower the collaterals, the higher the leverage a fund can accumulate. So, 'individual positions can be leveraged far more depending on the margin arrangement [with the bank]' (ibid).

2.6 Are hedge fund strategies stabilising or destabilising?

One of the most debated issues in relation to hedge funds is whether their strategies stabilise or destabilise price dynamics, where 'destabilising' means making prices more volatile. The economic literature distinguishes those hedge fund strategies or behaviours that increase volatility from those that do not.

In the previous section it was said that arbitrage funds profit from market discrepancies by buying undervalued assets (assets whose prices are too low compared to their potential earnings) and by selling short overvalued assets (assets whose price is too high compared to potential earnings). This strategy, which is called '*contrarian*', is said to push prices back to their 'natural' or equilibrium value and is therefore considered stabilising (Kodres 1998: 55-57, Deutsche Bundesbank 1999). As this implies a trade that goes contrary to what the market does (buying when the rest of the market is selling and selling when the market is buying), it is also called *negative feedback trading.*

The literature accounts for two types of destabilising behaviour. In the first type, players buy after prices increase and sell after prices decline. In other words, they buy overvalued assets and sell undervalued ones, thus pushing prices even further away from equilibrium level. For this reason, this practice is called *positive feedback trading* and is considered destabilising. On the one hand, hedge funds are supposed to act as contrarians and be more likely to pursue negative than positive feedback trading. On the other hand, however, some of the institutional features of hedge funds may lead to positive feedback behaviour. For instance, a common argument is that hedge funds have to put up margins in order to borrow assets from banks. When losses are incurred, hedge funds have to put up additional margins. It might happen that in order to do so they have to dismiss some of their positions, which can mean selling in a falling market. This is what happened to LTCM in August 1998.

The second type of destabilising behaviour is when 'participants take similar positions to those of other market participants rather than basing their decisions directly on prices' (Kodres 1998: 57). This behaviour is usually called 'herding'. Herding can be a consequence of managers being assessed against and compensated relative to a common benchmark or peer group: in this case, they might think that it is wiser to follow what other managers do in order to perform at least as well as their peers. The dominant view is that mutual fund managers, who are compensated relative to a benchmark, can be prone to this kind of behaviour, while hedge funds, which are compensated on the basis of the returns they produce, are unlikely to herd (ibid).

Another case of destabilising behaviour can occur with macro funds. Macro funds take directional bets on the likelihood of changes in macroeconomic fundamentals. It might be said that by so doing they push prices back to their fundamental value, as it was argued during the attack on the sterling pound in 1992. However, this practice might also affect price dynamics because of the sheer size of hedge fund positions in certain small markets or because of the collusion of various players in the same market. In this case, they increase volatility and can be destabilising.

Overall, the assumption that hedge funds act as *contrarian* investors and negative feedback traders has been dominant in regulatory and academic circles. Cases of destabilising behaviour by hedge funds were considered as the exception to the rule and in any case as a bearable consequence of their role as efficiency-providers (IMF 1998). This is one of the biases in the representation of hedge funds that the next chapter will challenge.

2.7 Number and assets under management

As a consequence of the lack of reporting requirements upon hedge funds, estimating their number and capital under management is a difficult task. As there are no official statistics, any analysis has to rely on the data provided by private sector companies (usually called 'vendors' or data providers), which in turn relies upon the information voluntarily released by hedge fund managers. The number of private data providers has been on the increase since the mid-1990s. The most well known are Managed Account Reports Inc. (Mar/Hedge), Hedge Fund Research (HFR), Van Hedge Fund Advisors (VHFA), TASS CSFB/Tremont Database and Financial Risk Management (FRM).[12]

This section provides estimates of hedge funds' numbers and capital under management both as aggregate figures and disaggregated by geographical location and strategy. Before doing so, however, the main methodological limitations of this study need to be spelled out. To begin with, no vendor has a thorough understanding of the hedge fund industry: they rely upon information voluntarily released by hedge fund managers and in any case upon a limited sample of hedge funds. A lot is open to interpretation and pure guessing, as 'strong inferences tend to be made on what is fundamentally fragile data' (De Brower 2001: 32). This is why data reported by different sources is notably different. Second, different vendors use different classifications, which may result in different estimates. In addition, the line between hedge funds and other kinds of funds is becoming blurred, so that many entities might remain excluded from classification, even though, from an economic point of view, they are the equivalent of hedge funds. Third, vendors very rarely make their estimates available to the public free of charge (Van Hedge Fund Advisors is the only provider that publishes its data on-line): most often their database is accessible only upon payment of high annual fees – which can amount to several thousand dollars. One way to overcome this limitation is to draw upon the

data reported by national and international regulatory agencies, which have access to the subscription-limited databases. This section draws upon the IMF Report (1998), the FSF Report (2000), the PWG Report (1999), and a study by De Brower (2001), a former member of the FSF Task Force on market dynamics. The IMF only uses Mar/Hedge data, while the FSF reports both VHFA and Mar/hedge statistics. Fourth, vendors are rarely an independent source of information on hedge funds. Many of them are part of bigger companies that are directly engaged in the management of hedge funds. Since 2000 many of the most well-known vendors have increasingly been acquired by management companies: for instance, CSFB/Tremont was acquired by Oppenheimer Fund, which is one of the biggest mutual fund companies both in the US and globally (Barr 2001d); the database of Mar/Hedge was acquired by the Zurich Group, an insurance-based financial services provider with a global reach (Gopalan 2001); and Financial Risk Management is owned by Goldman Sachs. Even when the vendor is not formally linked to any management company, its purpose is to provide information to potential investors in hedge funds and not to create historical databases. This problem is particularly felt in the assessment of hedge funds' performance, which is the subject of the next section. Fifth, many data providers (e.g. Mar/Hedge) have recently stopped issuing statistics on hedge funds out of concern about the reliability of their estimates (FSF 2001: 3). Therefore, data after 2000 are less and not more reliable. Sixth, there is a difference between the number of hedge funds and the number of hedge fund managers. The former is usually higher than the latter, as the same manager can manage more than one fund. Mar/Hedge, for instance, estimated that in 1999 the number of hedge funds was 3,000 and the number of managers 2,000. Databases might not always be able to separate the two categories.

Tables 2.1 and 2.2 show the quantitative relevance (respectively number and capital) of the hedge fund universe. They do so by collecting estimates from different databases. The lack of a

[12] See 'References' section for information on their websites.

full series of data from each vendor gives rise to inconsistency and makes the construction of historical data particularly spurious. It gives, though, an idea of the trend or tendency in the industry across time.

Data are reported from 1990 onwards for two main reasons: first, most statistics are available only from 1988 or 1990 and data before 1988 are extremely vague;[13] second, hedge funds experienced an explosive growth since mid-1980 and even more so with the spread of privatisation and financial liberalisation in the 1990s, which allowed them to diversify into emerging markets (Chada and Jansen 1998: 32).

The trend of this last decade is undoubtedly on the increase, both in terms of number of funds and of capital under management. At first sight there is a notable gap between Mar/hedge and Van Hedge statistics, which are the two most comprehensive databases reported in the tables: estimates made by the latter are almost double those made by the former. In percentage terms, however, both databases evidence a similar dramatic growth: according to Van Hedge, from 1990 to 2001 the number of hedge funds has grown by 279 percent and their capital by 870.15 percent; according to Mar/Hedge, from 1990 to 1999 their number has grown by 2262 percent and their capital by 2311 percent. The same growth is expected to continue: some providers report that assets managed by hedge funds will increase from approximately $500 billion today to $1.7 trillion in 2005 (Barra RogersCasey 2001: 1). Table 2.1 and 2.2 also integrates data from other providers. TASS database, for instance, estimates that capital under management in the industry in the year 2000 was about $450-500 billion. For the same year, Goldman Sachs and HFR speak of $400 billion (Lubochinsky et al. 2002: 34). The US President's Working Group (PWG) estimates that 'as of mid-1998 there were between 2,500 and 3,500 hedge funds

[13] TASS database provides information on hedge funds' assets only starting from 1994, as previous data are not considered meaningful (FSA 2002a: 9).

managing between $200 and 300 billion in capital, with approximately $800 billion to $1 trillion in total assets' (PWG 1999: 1).

This data concerns absolute numbers. What about the relative size of hedge funds – that is, their size in relation to other players or the market in which they operate? The PWG, for instance, points out that, although growing in absolute terms, hedge funds are still small compared to other US industries. The PWG reports that 'at the end of 1998 commercial banks had $4.1 trillion in total assets; mutual funds had assets of approximately $5 trillion; private pension funds had USD4.3 trillion and local retirement funds had $2.3 trillion; and insurance companies had assets of $3.7 trillion' (PWG 1999: 2). The IMF makes a similar argument (IMF 1998: 1). Other authors compare the $400 billion of the hedge fund industry with the total assets under management of mutual funds worldwide, which in 2000 were estimated at more than $4 trillion (Lubochinsky et al. 2002: 34). This means that the hedge fund industry is about 10 per cent the size of the worldwide mutual fund industry (ibid). These considerations led to the argument that if hedge funds are small compared to other players, their impact on the market will be minor too. As the next chapter will explain in greater detail, this argument is untenable for two main reasons: first, because hedge funds are questioned not for the capital they manage, but for the way they use this capital; second, because the portion of banks', mutual funds', pension funds' or insurance companies' activities that is devoted to hedge fund-investing needs to be added to the data on hedge funds.

Table 2.1 Number of hedge funds by vendors, location and style

Number/ Year													
	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Total													
VHFA*	1977	2373	2848	3417	4100	4700	5100	5500	5830	6200	6500	7000	7500
MAR**	127	170	245	361	526	698	904	1115	3000	3000			
TASS									1627				
HFR								1162					
By location													
US								569		4150	4250	4400	4600
Offshore								521		2050	2250	2600	2900
Europe								21				446	
Asia								1					
By style													
Arbitrage	24	28	47	72	103	133	170	213	310	274			
Macro	53	75	109	155	225	288	384	465	542	483			

TOTAL: *1990-1998 data (FSF 2000: 95); *1999-2002 data (VHFA); **1990-1997 data (Mar/Hedge in Chada and Jansen 1998: 30); **1998-1999 data (FSF 2000: 95 and Mar/Hedge). HFR figures for 1997 and TASS figures for 1998 are from Liang 2000: 311. BY LOCATION: 1997 data (Chada and Jansen 1998: 31); 1999-2002 data (VHFA); 2001 data for Europe (Euro Hedge, in FSA 2002: 10). BY STYLE: 1990-1997 (Mar/Hedge in Chada and Jansen 1998: 30); 1998-1999 (FSF 2000: 96). Macro is the sum of macro + emerging market funds; Arbitrage is the sum of market neutral + short sales funds.

Table 2.2 Hedge Fund capital under management by vendors, location and style (in $US bn)

Capital/ Year													
	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Total													
VHFA*	67	94	120	172	189	217	261	295	311	480	520	600	650
MAR**	8.5	12.7	19.1	37.4	48.7	53.3	76.3	145	175	205			
TASS									158			450/500	
HFR								112					
By location													
US								31.8		255	280	315	340
Offshore								75.4		225	240	285	310
Europe								2			28		
Asia													
By style													
Arbitrage	0.8	1.2	1.9	3.6	5.1	6.1	10.8	18.5	27.1	25.4			
Macro	6	9	13.3	25.5	32.4	33.7	45.9	60.6	64.1	59.9			

TOTAL: *1990-1998 data (FSF 2000: 95); **1999-2002 data (VHFA); **1990-1996 data (Mar/Hedge in Chada and Jansen 1998: 33); 1997-1999 data (Mar/Hedge). HFR figure for 1997 and TASS figure for 1998 are from Liang 2000: 311. TASS figure for 2001 is from FSA 2002: 10. BY LOCATION: 1997 data (Mar/Hedge Chada and Jansen 1998: 32); 1999-2002 data (VHFA); 2000 data for Europe is from HFR, in Lubochinsky et al. 2002: 34. BY STYLE: 1990-1997 (Mar/Hedge, in Chada and Jansen 1998: 33); 1998-1999 (FSF 2000: 96). Macro is the sum of macro + emerging market capital. Arbitrage is the sum of market neutral + short sales capital.

The other dimension worth looking at is the size of hedge funds in relation to the capacity of the market in which they operate. If they operate in advanced economies, their size is unlikely to cause market disruption (Tsatsaronis, interview 2003),[14] but if they operate in emerging markets or small open economies, their size can be quite large in relation to the size of the market and or central banks' reserves. Most importantly, their positions can be extremely concentrated. In the case of Hong Kong, for instance, the FSF Task Force estimated that in 1998 in the Hang Seng futures there was one instance when 'three hedge funds accounted for around half of the net open interest[15] of the entire market while one fund accounted for a third' (FSF 2000: 119).

Tables 2.1 and 2.2 also provide information on the geographical composition of the hedge fund universe. Table 2.2 shows that until 1998, hedge funds were located in the US or offshore, with only a scant presence in Europe and Asia. Things have changed since then and observers point to the growing share of the European market: Euro Hedge reports that the number of hedge funds managed in Europe rose from 317 to 446 during 2001 (FSA 2002: 10). HFR estimates that in 2000 the European hedge fund industry accounted for about $28 billion assets (Lubochinsky et al 2002: 34). Yet the US and offshore markets still account for the bulk of hedge funds, though it is not clear which one is the most significant location.

According to Van Hedge, the US is the first location for hedge funds both in terms of number and amount of capital under management. According to Mar/Hedge, instead, the US industry remains the first in terms of number, but only accounts for one third of the total if considered in terms of capital. An important distinction that these data do not make, however, is that between domicile and main place of business: many offshore funds are domiciled in the Cayman Islands or Bahamas, but they are managed from New York or

[14] Kostas Tsatsaronis is Head of Financial Institutions and Infrastructure, Bank for International Settlements.

another location in a principal financial market. A bill that was introduced to the Congress in 1999 to revise the US Bankruptcy code (HR 833) made exactly this distinction between domicile and principal place of business. The purpose of this distinction was to allow the latter to be the jurisdiction of a main insolvency proceeding of an offshore fund, but it could be used outside the Bankruptcy code. In this regard, also the distinction between hedge funds and hedge fund managers should be more effectively exploited: hedge funds might be domiciled in offshore centres, but their managers are in an on-shore market.

Considering the classification by investment styles, until 1997 macro funds were the most numerous with also the largest capital under management. In 1999, the growth of macro funds slowed down because of the 1998 emerging market turmoil, but both macro and market neutral funds started growing again in 2000. According to de Brower, this is partly due to a 'relief at no major regulatory changes in the United States' (De Brower 2001: 34). According to *The Financial Times* commentator Robert Clow, macro funds were also the fastest growing category in 2002 (Clow, interview 2002).[16]

In terms of average size of individual funds, figures vary greatly across investment styles. Table 2.2. divided by table 2.1 evidences that the biggest average size is in the macro fund segment, which also reports the highest concentration. According to Mar/Hedge, in 1997 the eight largest macro funds, with an asset of $1 to $6 billion, represented over 80 percent of macro hedge fund assets (Chada and Jansen 1998: 32). As for the rest of the funds, the PWG estimates that the vast majority of funds control less than $100 million in invested capital: 'there are perhaps only a few dozen hedge funds today that have a capital base larger than $1 billion, and only a small handful that exceed USD5 billion. The very largest hedge funds have less than $12 billion in investor capital, though some 'families' of funds have greater stakes' (PWG 1999: 2). These considerations have fed the argument of the quantitative

[15] Net open interest is the sum of all positions of all sign in a market.

insignificance of hedge funds. It has to be said, however, that the same manager can run different hedge funds, so that if one considers all the funds belonging to the same family the capital can go up to much more than $12 billion (De Brower 2001: 34). In addition, hedge funds entertain multiple relationships with the rest of the investment community (banks, prime brokers, mutual funds, insurance companies, etc.), as will be discussed in more detail in Chapter 3. It is important, therefore, to shift the emphasis from the size of the individual hedge fund to the size of hedge fund families and investment networks.

Finally, it might be worth asking why hedge funds have grown so fast. Two main reasons can be provided: (1) the growing polarisation of wealth on a global scale; (2) the increased appetite of pension and mutual funds, insurance companies, and banks for hedge fund investing. As for the first point, a good reference is the *World Wealth Report* compiled yearly by Cap Gemini Ernst & Young and Merrill Lynch. The 2002 edition shows that both the number of high-net-worth individuals and their aggregate wealth has been growing fast: their wealth was estimated at $27 trillion in 2001 and is expected to grow at 8 per cent per annum by 2006 (Cap Gemini 2002). The second point will be dealt with in Chapter 3, which discusses the growing importance of hedge fund strategies for traditional asset management. Here it is enough to mention that of the $1.7 trillion of expected growth in the hedge fund industry, at least half is due to come from institutional investors (Barra RogersCasey 2001: 1).

2.8 Hedge fund performance

Section two described how hedge funds were thought to produce superior investment performance, that is, to achieve higher-than-market returns with lower risk. But how do they

[16] Robert Clow is *The Financial Times* Correspondent from Wall Street, New York and an expert on hedge funds.

actually perform? Do they systematically outperform the market? This section tries to answer this question by considering and comparing some of the literature on the subject.

Usually, performance data are provided through three indicators: annual returns, standard deviation and Sharpe ratio. Standard deviation is a measure of the variability of returns and in Modern Portfolio Theory (the mainstream approach) equals risk. Sharpe ratio is a measure of returns in relation to risk of an investment strategy and it is calculated as the annualised monthly returns on the fund minus the return on a benchmark (usually the return on US Treasury bills, which is taken as a measure of the risk-free rate of returns) divided by the standard deviation. The Sharpe ratio gives what is called risk-adjusted returns. Scholars and practitioners (De Brower 2001: 36-37; Hills 1996: 91-109) argue that the Sharpe ratio is the best measure of performance, as the standard deviation only calculates the dispersion of returns around their mean but cannot properly assess the risk of a hedge fund, which claims to produce superior returns with lower risk. By putting returns in relation to a benchmark and then dividing them by their standard deviation, the Sharpe ratio is supposed to provide an estimate of this superiority.

The financial literature assessing the performance of hedge funds is growing larger and larger. Despite this, however, it remains subject to the same limitations that apply in the case of hedge fund numbers. To start with, it is the same data providers mentioned in the previous section – VHFA, Mar/Hedge, HFR, TASS, FRM, etc. – that collect information on hedge funds' performance and yet again they do so on the basis of what hedge fund managers voluntarily release. Since information on performance is that which interests (and attracts) potential investors in hedge funds, these data are the most critical, which means that they can be even more biased than data on number and capital under management. First, data may be biased upward as the worst performing managers are not going to provide information (IMF 1998: 5). As the low performers are unlikely to report, aggregate returns rise overall (Barra RogersCasey 2001: 15). Secondly, data might be biased because of the

specific interest of the vendor: providers have an interest in promoting the sector in which they operate, so as to sell more information. Thirdly, it is not only vendors that provide estimates of performance. An increasing number of financial economists have analysed the performance of hedge funds. The ideal of an independent research on hedge funds, however, is far from reality: many financial economists are also practitioners or have a link of one sort or another with hedge fund managers and consultants. Their results, therefore, might be as biased as those of data providers.

In addition to these biases, there are further difficulties in comparing estimates from different sources. This is due to the fact that different studies use different categorisations of hedge fund styles, different time-periods, different samples and different techniques, which all result in different estimates of the performance of hedge funds. To begin with, all these studies consider the returns of hedge funds by investment style, as aggregate values would hide significant differences across styles. Yet their categorizations are often profoundly different, which makes comparison of results extremely difficult. Second, estimates depend on the particular time-period examined, which is rarely the same across the literature. Third, samples are not the same as different studies draw upon different databases. Fourth, the economic models used to analyse data often diverge too. Keeping in mind both biases and limitations (Fung and Hsieh 2000a; Brealey and Kaplanis 2001), this section tries to answer the question of whether hedge funds systematically outperform the market and whether this can be attributed to the manager's skills.

De Brower draws upon three sets of data: Goldman Sachs/FRM, Mar/Hedge, and Van Hedge (Table 2.3). Only the first, however, provides data on standard deviation and Sharpe ratio. The return column evidences that hedge funds have under-performed key equity market indicators such as the S&P (US) equity index or the World Equity Index. According to De Brower, this might have been due to the extraordinarily high stock-market valuations of the late 1990s. Considering other time-periods (e.g. 1990-1995), in fact, Chada and

Jansen found that the average annual returns of the majority of hedge fund styles exceeded those of equity market and bond indices (Chada and Jansen 1998: 37-38). In terms of standard deviation, hedge funds have proved to be less volatile than the market. This is reflected in the Sharpe ratio: risk-adjusted returns for hedge funds are on average higher than for market benchmarks. In relation to bond markets, hedge funds did better even in terms of annual returns. Table 2.3 also evidences the difficulty of comparing estimates that use different style categorisations, different time-periods and different techniques (for instance, the risk of loss is not exactly like the standard deviation).

Table 2.4 reports the estimates provided by the Financial Stability Forum. They are based on data from Mar/Hedge and consider two different sample periods: 1990-1998 and 1990-1999. The FSF argues that while in the first sample-period only one style ('global established') performed as well as the market, in the second sample-period 7 strategies performed as well as or better than the market. Yet, even in the second time-period hedge funds have not outperformed the market in any noticeable way and the very fact that results from two different time periods differ implies that hedge funds have not outperformed the market in any *systematic* way.

Table 2.3 Performance estimates: Goldman Sachs & FRM, Mar/Hedge and Van Hedge

Goldman Sachs and FRM, 1994-98				Mar/Hedge, 1995-99		Van Hedge, 1995-99		
Strategy	Return (%)	Standard deviation	Sharpe ratio	Fund style	Return (%)	Fund style	Return (%)	Risk of loss (%)
Market neutral	11.9	2.3	2.9	Market neutral	12.3	Neutral-arbitrage	15.0	5.7
Long/short	15.2	7.3	1.4	Short sellers	-2.7	Neutral-securities	18.3	14.8
Event driven	12.7	4.6	1.6	Long only	n/a	Distressed assets	12.3	11.5
Tactical trading	17.0	9.3	1.3	Sector	n/a	Special situations	22.6	8.5
				Event-driven	14.4	Short selling	-10.3	57.5
				Global internat.	14.8	Value	24.1	13.6
				Global emerg.	13.6	Growth	33.8	14.4
				Global est.	23.8	Emerging market	7.5	42.6
				Global Macro	12.6	Market timing	24.0	15.7
				Fund of funds	12.8	Opportunistic	26.4	10.7
						Income	6.6	9.4
						Several strategies	19.9	6.3
						Macro	19.2	24.2
						Funds of funds	16.1	11.3
Bond Index	7.3	4.1	0.5					
S&P	24.1	13.9	1.4	S&P500	28.6	S&P500	28.6	-
World Index	12.9	13.0	0.7	World Index	18.1	World Index	18.1	-

Source: De Brower 2001: 35. Notes: in Goldman Sachs estimates, the World Index is the FTSE world index; in Mar/Hedge and Van Hedge estimates, the World Index is the Morgan Stanley Capital International Index; bond index is the Lehman Brothers Aggregate Bond Index.

Table 2.4 Performance estimates: FSF report

	Sample period Jan 1990-Aug 1999			Sample period Jan 1990-Aug 1998		
	Average Excess Returns	Standard deviation	Sharpe ratio	Average Excess Returns	Standard deviation	Sharpe ratio
Event driven	10.3	9.7	1.1	12.4	7.9	1.6
Global Macro	16.6	18.1	0.9	19.7	16.7	1.2
Global International	8.3	13.1	0.6	11.0	11.3	1.0
Global Emerging	26.7	41.1	0.7	34.0	37.3	0.9
Global Established	13.9	10.4	1.3	14.5	10.6	1.4
Sector	20.6	17.7	1.2	22.0	17.6	1.2
Market Neutral	6.4	5.3	1.2	7.5	4.6	1.6
Long	16.8	15.5	1.1	19.9	14.2	1.4
Short	2.6	11.5	0.2	1.6	11.7	0.1
Funds of funds	8.3	9.8	0.8	10.0	9.1	1.1
All funds	13.5	12.2	1.1	15.8	11.1	1.4
S&P	14.7	11.5	1.3	14.2	11.8	1.2

Source: FSF 2000: 103. Average excess returns is defined as return in excess of the US Treasure Bill Yield (numerator of the Sharpe ratio)

Other studies support this scepticism over hedge funds' superior performance. Agarwal and Naik (2000), for instance, show that the Sharpe ratio for a sample of funds following 10 different strategies in the period 1990-1998 is 0.21, while the Sharpe ratio for the market benchmark (which in this case is the Russell 3000) is 0.19. The gap is not significant, which means that hedge funds did not substantially outperform the market, though if only non-directional strategies are taken into account the difference is more noticeable (Sharpe ratio in this case is 0.31 against 0.19 for the benchmark).

Table 2.5 Performance estimates: Agarwal and Naik

Hedge fund strategy	Standard deviation (%)	Sharpe ratio
Non-directional		
Event arbitrage	1.81	0.37
Event-driven	3.55	0.31
Equity hedge	5.28	0.29
Restructuring	3.11	0.18
Fixed income arbitrage	2.35	0.34
Capital structure arbitrage	1.92	0.39
Average	**3.00**	**0.31**
Directional		
Macro	4.69	0.18
Long	7.37	-0.04
Hedge (long Bias)	6.17	0.19
Short	7.45	0.10
Average	**6.42**	**0.11**
Average directional and non-directional	**4.71**	**0.21**
Russell 3000 Index	**3.67**	**0.19**
World Index (- US)	4.96	0.01
Bond	1.52	0.22

Source: Agarwal and Naik 2000: 39

Even more ambiguous are the results by Ackermann et al. (1999). According to this study, hedge funds do not consistently outperform market indexes. Data from this study are not reported, as they are not comparable (the authors use different indicators). However, the authors conclude that hedge funds do not produce higher-than-market returns with lower risk.

There are, however, results in favour of the argument of hedge funds' superiority. Lubochinsky et al. (Table 2.6) show that in relation to the time-period 1996-2000 most hedge fund strategies evidenced higher Sharpe ratios than the S&P500 (and even more so in relation to bonds). Results vary across styles, with some of them (e.g. short selling, emerging markets) showing higher levels of risk and lower returns than market benchmarks, but in general this study shows that the majority of funds outperformed the market. Similar conclusions can be drawn from Jaeger (2001), in which the Sharpe ratio is calculated for the period 1990-2001 (Table 2.6), considering both the TASS and HFR databases. Despite differences in the TASS and HFR estimates, the study shows that the Sharpe ratio for hedge fund strategies is in general higher than that of various market benchmarks. Similar results are also reported in Barra RogersCasey 2001: 14.

While different studies report different results about hedge funds' performance in relation to market benchmarks, there is much agreement on how hedge funds perform in relation to mutual funds. Ackermann et al. (1999) suggest that while hedge funds do not consistently outperform market aggregates, they instead outperform mutual funds, though hedge funds remain significantly more volatile. Another common finding is that hedge fund returns are substantially uncorrelated with market benchmarks (Jaeger 2001; PWG 1999), especially bond indices, and that for this reason their inclusion in traditional portfolios would provide insurance against market downturns (FSF 2000: 91). This argument is widespread in the literature. Funds of funds, which group different hedge fund strategies under the same umbrella, are particularly cited as a suitable alternative to mutual funds for diversification purposes: as correlation among different hedge fund strategies is low and as funds of funds invest in a variety of such strategies, they are said to diversify risk away (Schneeweis et al. 2000; Hills 1996).

Table 2.6 Performance estimates: other samples.

Data from HFR, 1996-2000, Lubochinsky, C. *et al.*				Data from HFR and TASS, 1990-2001, Jaeger (2001)			
Fund style	Annual return (%)	Annual standard deviation (%)	Sharpe ratio	Fund style	Annual return (%)	Annual standard deviation (%)	Sharpe ratio
Convertible arbitrage	12.83	3.41	2.29	Distressed securities (HFR)	15.50	6.47	1.62
Emerging markets (total)	12.14	19.42	0.37	Long/Short Equity (HFR)	20.22	9.29	1.64
Equity hedge	27.33	10.59	2.11	Long/Short Equity (TASS)	13.40	12.05	0.70
Equity market neutral	10.81	3.57	1.62	Equity market neutral (HFR)	11.28	3.26	1.93
Equity non-hedge	24.46	15.44	1.26	Equity market neutral (TASS)	11.11	3.19	1.92
Event-driven	17.95	7.35	1.76	Event-driven (HFR)	15.96	6.75	1.76
Fixed income (total)	8.74	3.94	0.94	Event-driven (TASS)	11.83	6.53	1.05
Fixed income: arbitrage	3.63	5.37	-	Macro (HFR)	17.78	8.88	1.44
Fixed income: convertible bonds	21.41	11.83	1.39	Macro (TASS)	14.06	13.46	0.67
Fixed income: diversified	6.33	3.22	0.40	Market timing (HFR)	14.55	6.98	1.37
Fixed income: high yield	7.11	5.68	0.37			11.83	1.39
Macro index	13.62	8.35	1.03	Regulation D (HFR)	23.04	7.28	2.48
Market timing	20.66	7.97	1.96			5.68	0.37
Relative value arbitrage	15.31	3.53	2.91	Convertible arbitrage (HFR)	12.01	3.42	2.05
Sector (total)	29.36	16.74	1.45	Convertible arbitrage (TASS)	11.13	4.89	1.25
Short selling	-11.59	23.67	-	Fixed income arbitrage (HFR)	8.62	4.84	0.75
Statistical arbitrage	10.98	4.09	1.46	Fixed income arbitrage (TASS)	7.69	4.83	0.56
Fund weighted composite	18.39	8.80	1.52	Short selling (HFR)	2.99	23.22	-0.09
Fund of funds	13.63	7.93	1.08	Short selling (TASS)	-0.10	18.42	-0.28
				Funds of funds (HFR)	10.99	6.11	0.98
Equities (S&P500)	16.82	14.32	0.82	Composite (HFR)	15.80	7.34	1.47
Bonds	2.98	5.30	-	Composite (TASS)	11.88	9.36	0.73
				Equities (S&P500)	9.73	14.54	0.32
				World equity	4.40	14.69	-0.04
				Bonds	7.32	6.04	0.38

Sources: First column: data from HFR, sample period: 1996-2000, in Lubochinsky, C. et al.; Second column: data from HFR and TASS, sample period: 1990-2001, in Jaeger (2001).

Finally, given the fact that hedge funds charge 20 percent performance fees and that they are known as 'skill-based' strategies, a crucial question is whether hedge funds' returns are correlated to the manager's skills. Financial economists measure this relationship by looking at *persistence* in the performance of hedge funds. The idea is that 'no persistence means no skills'. Some authors (Edwards and Caglayan 2001) found evidence of significant persistence over one and two year horizons – though to different extents for different styles. Other authors (Brown et al.: 2000) found no persistence in their sample analysis; some others (Agarwal and Naik 2000) found that persistence is only short term in nature and does not go beyond a quarter (and this in contrast to mutual funds, that instead have a two year-persistence horizon).

To conclude, it seems that there is no clear-cut answer as to the question concerning whether hedge funds outperform the market. This is because of the considerable biases and difficulties in estimating hedge funds' adjusted-returns. Overall, there is mixed evidence because the studies here reported lead to rather different, if not opposite, results. This is without considering that the very measure of risk used in the Sharpe ratio might not be able to catch all the risks incurred by hedge funds (Lubochinsky et al. 2001: 39). Risk related to high leverage, for instance, is generally not taken into account in the calculations. There is instead more agreement that hedge funds perform better than mutual funds. It is also agreed that, as they are not correlated to the returns of traditional buy-and-hold approaches, hedge funds can be a good diversification tool to be included in traditional portfolios. But scholars are again divided as to whether this better-than-mutual-funds performance should be attributed to the manager's skills – and thus justifies the 20 percent performance-fees – or instead to their regulatory regime, luck, etc. Estimates based on persistence of returns are indeed unconvincing. As (Anonymous 5), says:

> There are fewer 'smart' managers than managers would have you believe: performance is not persistent and there are a very small number of good hedge funds (Anonymous 5, interview 2003).

PART TWO

A distinction needs to be drawn between the history of hedge funds and the history of the political and regulatory debate on hedge funds. Hedge funds have operated since 1949 and most of the time they have done so in relative secrecy. It is only with the financial crises of the 1990s and especially the 1997 Asian currency crisis that hedge funds became perceived as a political issue and a regulatory concern (Fung and Hsieh 2000b: 2). The political debate on hedge funds, therefore, is no older than a decade. To focus on this aspect of the history of hedge funds, the following six sections will mainly review the events from 1992 onwards. Only the first section goes back in time to the beginning of hedge fund investment.

2.9 History of hedge funds from 1949 until the mid-1980s

After Jones's invention, hedge funds did not immediately spread into the investment community. Things changed only in April 1966, when *Fortune* published an article praising the virtues of this kind of investment vehicle (Loomis 1966 cited in Caldwell 1995: 9). It was the first of a series of instances in which the financial press influenced the history of hedge funds. The article reported that Jones's fund was able to get returns well above those of the most famous mutual funds of the time (e.g. Fidelity Trend Fund and Dreyfus Fund).[17] This reportedly triggered a wave of emulations that brought about the launch of 140 hedge funds by the end of 1968 (Caldwell 1995: 10). George Soros's and Michael Steinhardt's funds were among them.

With the market downturn following the two oil shocks, many hedge funds did not survive and the few that did operated in secrecy until the mid-1980s. It was once again an article in

the financial press that allegedly triggered a second wave of interest in the hedge fund industry. This time the attention focused on Tiger Fund, which later became one of the biggest and most well known hedge funds of all time. In *The Red Hot World of Julian Robertson* (Rohrer 1986 cited in Caldwell 1995: 11), hedge funds were once again praised for their outstanding returns. The article reported that in the first six years of its activity (between 1980 and 1986) Tiger Fund, managed by Julian Robertson, achieved net returns of 43 per cent, while in the same period of time S&P500 returns were only 18.7 per cent (Caldwell 1995: 11-13). In 1985 Robertson made his first macro-operation, which was a bet on the depreciation of the dollar against the Swiss franc, the deutsche Mark, sterling, and the yen. Tiger and its offshore sister Jaguar bought 7 million dollars of call options (contracts that gave Tiger the right to buy dollar against foreign currency at a prearranged date), so that when the dollar lost value against the other currencies, Tiger was able to buy dollars cheap and sell foreign currencies dear, profiting from changes in the exchange rate (Manuli 1999: 4-5; Caldwell 1995: 12).

Tiger is also described as using 'new financial instruments' (derivatives) to prudently hedge market risk and improve on Jones's model. Robertson himself used the phrase 'new modalities' to describe innovations in financial futures and options (ibid). This matches the testimony of other practitioners (Karki, interview 2002),[18] who describe how the market only slowly reacted to the introduction of futures and options contracts in the 1970s. So, it is plausible to think that in the mid-1980s derivatives such as options and futures were still very new and used by hedge funds as precursors in anticipation of their mass adoption in the 1990s. This is one further reason why hedge funds came to be perceived as 'always one step ahead of the market'. One year later, in 1987, Soros published '*The alchemy of finance:*

[17] Loomis' article – 'The Jones Nobody Keeps Up With' – showed that Jones's fund bettered Fidelity Trend Fund by 44 percent over a five-year period and Dreyfus Fund by 87 percent over a ten-year period.

[18] Jaakko P. Karki is Director of Research at International Asset Management (IAM), London.

reading the mind of the market', where his ideas of staying 'ahead of the curve' are best exemplified.

Soros started trading much earlier than 1987 though: he launched his first hedge fund in 1969 (Soros 1987: 13). Accounts of Soros's operations are made by Soros himself in *The Alchemy of Finance*, where he described how his market theories proved successful in the conglomerate booms of the 1960s and the real estate boom (REIT) of the 1970s. Economists and market analysts have since then referred to his work and even created economic models out of his investment strategies (Shleifer 2000).

Soros says that his success at the time depended on his *contrarian* strategy, which consists in discovering the model of behaviour of the other investors and in doing the direct opposite of what they do. He was convinced that investors do not behave according to the efficiency paradigm – that is, they do not follow economic fundamentals – but according to the laws of what he called 'reflexivity'. In his words, there is 'a flaw in the participants' perception of the fundamentals' (Soros 1987: 54) that makes them easy to be manipulated.

Soros says he first used this approach during the conglomerates boom of the 1960s. He says: 'The key to the conglomerate boom was a prevailing misconception among investors' (Soros 1987: 56). The misconception developed out of the exceptional growth rates of certain high-technology companies in the early 1960s. Investors got excited about the increase in earnings per share and started buying conglomerates without questioning the way these companies produced earnings. The managers of these high-technology companies realised that they could produce earnings growth through acquisitions and started acquiring companies that had the same intrinsic growth in earnings but that sold at half the price of the acquiring company. Soros writes: 'If the acquiring company manages to double its size its earnings per share jump by 50% and its growth rate increases accordingly' (Soros 1987: 56). 'Investors responded like Indians to firewater' (Soros 1987: 57). The buying - and with it

the prices - went on and on until earnings expectations were not fulfilled and prices collapsed. Soros's strategy was to buy in anticipation of further buying and then to sell when prices reached their maximum before decreasing. As he subsequently wrote, 'it enabled me to make money both on the way up and on the way down' (Soros 1987: 56).

Soros says that another instance in which his financial strategy worked out exactly as he planned was the real estate investment trusts (REITs) boom of the early 1970s.[19] In this case his involvement was even greater. He reports that the boom started with a report he circulated on the return prospects of REITs. As Soros writes, 'I published a brokerage report that forecast a boom-bust process, and afterwards the scenario played out, like a Greek drama, exactly as I predicted' (Soros 1999: 77). Demand for REIT shares grew quickly and this helped push up their prices.[20] As a consequence, new REITs were issued. Soros reports that he first increased his position and then

> Decided to sell the group [REITs] short more or less indiscriminately. Moreover, as the shares fell I maintained the same level of exposure by selling additional shares short. My original prediction was fulfilled and most REITs went broke. The result was that I reaped more than 100% profit on my short positions [...] (Soros 1987: 64)

Despite the fact that boom/bust circles do not happen every day, Soros argues that 'the divergence between underlying trends and investor recognition persists at all times and the *astute* investor can take advantage of it' (Soros 1987: 65, my italics). Soros's story demonstrates two important things. First, Jones's idea of the importance of the manager in picking up the right stocks is amplified by the recognition that smart managers can defeat academic theories as well as the market. The role of Soros's report in the REIT boom is a case in point. Second, and as a consequence of the previous point, this has produced a legitimisation of what Soros calls 'indiscriminate short selling' (Soros 1987: 64). There has

[19] REITs or mortgage trusts are special corporate forms that allow companies to distribute income free of corporate taxation provided they distribute all the income they receive.
[20] Other sources point out that, rather than from Soros's report, the REIT boom originated from new legislation, enacted in 1960, providing exemption from corporate income tax for qualified trusts (see for instance Rosenberg 2000: 13.

been more admiration/emulation than resentment throughout the market. This has had powerful effects: traders admit that in many cases their daily information consisted of a listing of Soros's current or future market moves. It is likely that this helped Soros put up his bet against the sterling pound in 1992.

2.10 The currency crises of the 1990s

Both the Exchange Rate Mechanism (ERM) crisis of 1992 and the Asian crises of 1997 concerned those hedge funds operating in currency markets, so-called global macro funds (see section 2.5). 'Macro' means that they profit from expected changes in macroeconomic conditions affecting the exchange and/or interest rate and 'global' that they can operate potentially in any market. Soros's funds belong to this category. Macro funds are said to differ from Jones's model as they do not 'hedge' in the sense of covering long positions with short ones, but instead take 'directional bets' on the likelihood of a devaluation in a currency or a set of currencies. However, as explained in section 2.6, they somehow use Jones's formula, as they still combine short and long positions (e.g. spot and swap market) to maximise their speculative activities.

The first currency crisis where hedge funds featured significantly was the ERM crisis of 1992. As textbooks say, the ERM crisis is the end result of the convergence play operated between European currencies pegged within the ERM. Between 1987 and 1991, investors started getting cheap funding in currencies such as the deutsche Mark to invest in high-yielding currencies such as the Italian lira. They held the belief that exchange rates were credibly pegged within the ERM and thus that the parity would be maintained. As soon as credibility eroded, hedge funds started shorting European currencies such as the Italian lira in the expectation of being able to buy them back at lower prices once the devaluation had occurred. Famous is the case of the sterling pound, where Soros's fund was able to put together a $10 billion bet against the currency and to force the Bank of England to

eventually devalue after spending 3 billion pounds to maintain the peg. According to the IMF, hedge funds were ahead of other investors, that is, they acted as *market leaders*:

> If hedge funds played a role in precipitating the crisis, they did so by acting as market leaders that other institutional investors followed... [A]lthough hedge funds have less than $10 billion in capital, their potential influence on forex markets [was] larger. But mutual funds, pension funds, insurance companies, and non-financial corporations provided the real financial muscle (IMF 1993: 11).

Accounts like this re-enforced the idea of hedge funds as smart investors that everyone else is willing to follow. The ERM crisis also signalled the beginning of a new kind of popularity for hedge fund managers: they became the most blamed actors in any currency crisis of the decade.

So, in 1997 hedge funds were immediately implicated in the attacks suffered by East Asian currencies. As in the case of the ERM, some years before the crisis investors started funding themselves in dollars and yen (at cheap rates) and investing those funds in high-yielding East Asian fixed-income securities. This strategy – called 'carry trade' – was made possible by the currency pegs in place in countries such as Thailand, Indonesia and Malaysia. Beginning in 1996, those currencies came under increasing pressures and were eventually devalued in 1997 with the dismantling of many currency pegs. The currency attacks first took place in Thailand in May-July 1997, followed by Indonesia, South Korea, Malaysia and the Philippines.

In 1997, in the aftermath of the Thai devaluation and the spreading of the contagion to other East Asian countries, hedge funds were soon accused of being possible culprits. There was a strong demand particularly from Asian countries to address the role that hedge funds performed in the crisis. Mahathir's statement that George Soros and other Western global macro funds – the 'highwaymen' of the financial market – had heavily bet against East Asian currencies could not remain unanswered. It was at that time that hedge funds entered the political debate on the reform of the Global Financial Architecture.

The IMF was the first to address this issue with the occasional paper *Hedge funds and Financial Markets Dynamics*, which was prepared by a team of IMF economists led by Barry Eichengreen (IMF 1998). The IMF packaged a very detailed analysis, which went beyond the events of the Asian financial crisis. It was the first publication on hedge funds with a regulatory intent. The IMF paper made four main claims. First, it pointed to the quantitative irrelevance of hedge funds compared to other market players. The paper writes that, 'while hedge funds are large in absolute terms they are dwarfed by other institutional investors (banks, pension funds, mutual funds), some of which engage in many of the same activities as hedge funds' (IMF 1998: 1). Foreign commercial and investment banks as well as domestic banks and corporations were said to have played a larger role in the crisis than the one played by hedge funds. Second, the paper denied hedge funds' involvement by looking at the timing of the attack. According to the IMF, the bulk of hedge funds' forward sales to the Bank of Thailand occurred only in May 1997, in what was considered to be the tail end of the process. This was taken to prove that they did not lead the process but were instead 'at the rear, not the front, of the herd, which appears to have been led by domestic corporates, domestic banks, and international commercial and investment banks' (IMF 1998: 18). Therefore, both the quantitative power of hedge funds (e.g. power of number and size) and the power of triggering herding behaviour were dismissed right away. Third, the paper claimed that at the time of the attack hedge funds were buying instead of shorting the currencies of the affected countries. Again, the IMF study attributed the bulk of the forward selling of the Thai baht to domestic banks, domestic corporates and international banks, who were said to have been the first to close their long positions, short the currency and rush to cover their dollar exposure. Finally, the Thai baht is considered to be the only currency in which hedge funds took significant short positions. Minor positions were observed in the case of the Indonesian rupiah, where hedge funds were reported to have lost money for not having anticipated the extent of the depreciation. Once again domestic and international banks and corporates were assigned a major role in the rupiah devaluation due to their rush

to hedge their exposures in dollar. Hedge funds reportedly incurred losses in the case of the Philippine peso and the Malaysia ringgit as well (IMF 1998: 18). For all these reasons the IMF paper confidently dismisses the role of hedge funds in the crisis.

The paper was not well received among emerging markets and in general those economies that suffered the consequences of the currency attacks. The IMF was said to confuse the issue by comparing the capabilities of hedge funds with those of banks, without considering that in Thailand and Malaysia the size of hedge funds was considerable *in relation* to the size of those domestic markets. Some countries also questioned the very methodology of the paper, which only relied upon interviews with hedge fund managers and which was prepared by professionals with strong links to the hedge fund industry (Anonymous 1, interview 2003). The IMF paper was seen as a fully political paper, which tried to legitimise a no-action policy against hedge funds and put the blame on domestic economies. This view is legitimised by the very conclusions of the IMF paper:

> The analysis [...] does not suggest a strong case for supervisory and regulatory measures such as these targeted specifically at hedge funds. [...] The analysis suggests that the most important action policymakers can take to protect their economies against uncomfortable market movements is to avoid offering one-way bets in the form of inconsistent policies and indefensible currency pegs. They need to adopt policies that keep their economies away from the "zone of vulnerability" where multiple equilibria and self-fulfilling speculative attacks can arise (IMF 1998: 4).

The IMF paper expressed a widespread view among US academics. Another paper that came out in the same month (Brown et al. 1998) – made a similar argument about hedge funds' involvement in the crisis. In order to test Mahathir's claim that hedge fund operators like George Soros were responsible for the crash in the Malaysian ringgit, the authors assessed 'the dollar exposure of the top ten global hedge funds to Asian currencies before and during the crisis' (Brown et al. 1998: 1).[21] In order to estimate whether there was

[21] They collect data from TASS, the major data provider for the hedge fund industry, and from Paradigm Asset Management. The funds selected are: Capital International Emerging Markets Fund, Everest Capital International Limited, Hausmann Holdings NV, Jaguar Fund, Orbis Global Equity

currency manipulation, they measure the variation of the exchange rate following a variation in the fund's (or funds') exposure to that currency. They use reported returns (obtained through interviews) to infer the managers' exposure to the currency. 'If the currency markets were being manipulated by hedge funds, we would expect a positive association between exposure and change in the currencies' (ibid: 6).

As in the IMF paper, Brown et al. found that hedge funds were not responsible for the attack, both because they were not the largest players and because of the timing of the attack. First, the total capitalisation of these ten global macro funds in September 1997 was reported to be $29 billion, which pales in significance when compared to the daily volume of foreign exchange (in the trillions of dollars). Second, the timing of the attack evidences that there was no correlation between these macro funds' negative exposure to the ringgit (e.g. short positions in the ringgit) and shocks to the currency. There were times – the authors say – when these funds were levered eight times in their negative exposures to the ringgit and nothing happened.[22] On the other hand, in the months leading to the crisis (between June and September 1997), when the ringgit dropped by 10 per cent, the net hedge funds' exposure to the ringgit was close to zero. Their conclusion is that hedge funds' exposure does not corroborate Mahathir's claim. They repeated the analysis for a basket of Asian currencies and showed that the results did not change.

Two years later the FSF Task Force partly disproved this argument by providing some evidence of the role of hedge funds in moving markets in Asia. It was perhaps the only achievement of the FSF regulatory debate on hedge funds and will be analysed at length in Chapters 4 and 5. The FSF Task force also analysed other currency attacks that took place in 1998 in a group of small and open economies (South Africa, Australia, New Zealand,

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Fund, Orbis Optimal Equity Fund, Quantum Fund, Quasar Fund, Quota Fund, and Swiss Bank Corporation Currency Portfolio Ltd.

[22] For instance, they report how in February 1996 those funds were short the ringgit by $200 billion, which is a considerable amount, but no shock to the currency was registered.

Singapore, Malaysia and Hong Kong). However, despite the partial acknowledgement that hedge funds played a role in the financial crises of 1997 and 1998, FSF regulators did not take any major policy initiative to tackle their operation in currency crises (Chapter 5). It can be said, therefore, that despite the role hedge funds allegedly played in the currency crises of the 1990s, their regulatory regime has not been modified as a consequence of that.

2.11 LTCM: near collapse and rescue

The near-collapse of Long Term Capital Management in August 1998 brought hedge funds back to the headlines. The potential domino effect that the failure of a big hedge fund could have produced even in a major market like the US became a major area of concern for regulators and, as will be explained below, the reason that triggered the international regulatory debate on hedge funds. Concerns were augmented by the fact that a three billion dollar bailout had to be orchestrated by the Federal Reserve Bank of New York – though with private banks' money; that an almost equivalent amount of money had to be pumped into US financial markets to help stabilise the economy; and that an interest rate cut had to be implemented.

The literature on LTCM has grown even bigger than the one on the Asian crisis. There has been a flood of press articles, both during and in the aftermath of LTCM's near-collapse and rescue. Several books were written between 2000 and 2001 (Lowenstein 2001; Dunbar 2000; Temple 2001) and a few academic papers have appeared since 1998 (Stonham 1999a and 1999b; De Goede 2001). This is partly justified by the fact that this hedge fund was set up by two Nobel laureates, Robert Merton and Myron Scholes, and run by a prestigious veteran of financial markets, John Meriwether. All sources point to the image of respectability that surrounded such a quality fund that allowed it to gain credit at very favourable terms. 'Too good to question and to fail', it was said. This reiterated an image of hedge funds as exceptional investment vehicles run by particularly smart managers.

The way in which LTCM managers are referred in these books is exemplary of this tendency: they are described as 'masters of the universe', 'market wizards', or – in one case – as 'Archimedes of Greenwich' (Lowenstein 2001; Dunbar 2000; Temple 2001). They are perceived as exceptionally smart individuals, with the right knowledge and skills to obtain returns above any average. Apart from rehearsing the idea of hedge funds as skill-based strategies, this explanation was used to justify why they were granted so favourable credit terms, why they were not asked to provide more information on their strategies, why their risk management was not questioned, and why they were supported in their 'undue reliance on mathematics' (Temple 2001: 97) and their excessive use of leverage. This explanation, however, was also useful to argue that this is not what *normally* happens to other hedge funds and that LTCM was, even in this respect, exceptional.

LTCM was not a global macro fund. For those who said during the Asian crisis, 'Soros and the like are not really hedge funds as they do not follow Jones's model of hedging short bets with long positions', LTCM represented the 'typical' Jones-type of hedge fund. It followed a *market-neutral* or *arbitrage* strategy, which, as seen in section 2.5, attempts to detect and profit from price discrepancies between similar assets. Contrary to macro funds, these strategies were seen as 'not dependent on the market causing interest rates to rise or fall, but rather on the yields converging on securities bought and sold short' (Stonham 1999b: 385), that is, on the manager's ability to pick the right securities. Arbitrage funds buy under-priced securities and sell short over-priced ones, betting that the spread between the two assets narrows (ibid). By so doing, they are supposed to help markets achieve equilibrium and thus to enhance efficiency. For instance, LTCM could buy cheaper Italian bonds and sell short more expensive German bonds expecting that the yields on the two sets of bonds (and their price) would converge (Temple 2001: 108, Lowenstein 2001: 54-59; Dunbar 2000: 124). Another play could be to buy emerging market bonds, i.e. Brazilian bonds, and sell short US Treasury bonds, betting that the yields between mature and emerging market

bonds would align. If this happened, the fund would experience a rise in the price of the item it bought and a fall in the price of the item it sold short (and that it had to buy back to repay), therefore gaining on both sides of the trade. 'The longs and shorts were meant to hedge each other out and reduce or *eliminate* market risk' (Stonham 1999b: 386, my italics). That was seen as a win-win situation (and as a risk-free strategy) and therefore leverage could be applied to it to maximise returns. Leverage was also necessary as discrepancies between prices were minimal and therefore needed to be amplified by leverage in order to make more money out of it (ibid). As is clear from section 2.3, this perfectly follows Jones's model and his idea of hedging. As Temple writes, 'Meriwether was fascinated by the idea of arbitrage, the idea that profits can be made from market inefficiencies in a riskless manner simply by superior reasoning and a scientific approach' (Temple 2001: 96).

Contrary to LTCM managers' expectations, in 1998 the Russian debt default and the *flight to quality* towards bond investment made the yield spreads between emerging and advanced markets assets diverge instead of converging (Stonham 1999b: 386). LTCM managers found themselves with open positions in assets whose prices were soaring. To close those positions they had to raise liquidity, and thus dismiss assets in other markets, precipitating price falls even in unrelated markets. LTCM's high levels of leverage (50 to 1 in the period leading to the collapse) and its extensive use of derivatives precipitated the situation (ibid).

Orthodox economics explained the failure of LTCM mainly in terms of a *random external shock.* As Stonham writes, 'the *fundamental reason* for LTCM's loss of value lay in large movements in financial markets worldwide and macroeconomic events, although [...] the effects were compounded by the nature of LTCM's trading at that time, and its high leverage. [LTCM strategy] was one among several that was *disrupted by events*' (Stonham 1999b: 384, my italics). Greenspan and McDonough, respectively chairmen of the FED Board and of the Federal Reserve of New York, made the same point at their testimony before the US House of Representatives (Chapter 1: 31). Regulators in Washington and

Basel shared this view too (Lall, interview 2002; Raikes and Bennett, interview 2002; Freeland, interview 2003).[23] What happened to LTCM, in other words, was seen as exceptional, unpredictable, and out of regulatory control.

When LTCM started plunging, regulators feared for the possible systemic risk impact. By August 1998 LTCM equity capital dropped to 1.5 billion from $4.3 billion at the beginning of 1998 (Corvi 2000) and plunged to $600 million by the time of the rescue in September 1998 (Stonham 1999b: 383). In order to prevent LTCM from bringing down a core part of the financial system, the Fed stepped in.

LTCM also brought to light the multifarious interests that banks hold in the hedge fund industry. It was clear that banks heavily lent to hedge funds and that the bailout was orchestrated prevalently in their own interest: LTCM's seventeen biggest counterparties – which include banks such as Merrill Lynch, Goldman, Morgan Stanley and Salomon Smith Barney – would have lost at least $2.8 billion had the bailout not been organised (Lowenstein 2001:188). In general, two main explanations of banks' involvement were given. The first is that banks' role is one of meeting their clients' requests and that, by so doing they can fail to judge the riskness of their operations (Dunbar 2000). In the case of LTCM, the allure of geniality that surrounded the Fund's managers confused banks' judgements (Andresen interview 2003). The second explanation is that banks were perfectly aware of LTCM trades and knew that they could make money out of it. According to Lowenstein, it is LTCM that was 'at such rivals' tender mercy' (Lowenstein 2001: 175). What is more, Salomon Smith Barney, UBS, Société Générale, Bankers Trust, and Morgan Stanley all apparently refused to take the other side of the contract when LTCM's troubles started (ibid). This is why LTCM's losses mounted and the fund could not pay its trades. Chapters 4 to 5 will discuss the issue of banks' involvement by privileging this second explanation.

[23] See the section 'List of Interviews' for details about interviewees.

The Asian crisis and the near-failure of LTCM were the two events that triggered the regulatory debate on hedge funds. Since then, however, hedge funds were brought into the spotlight on at least three other major occasions: the Internet bubble in March 2000; the aftermath of September 11; and some episodes of 'vulture investing'. These market events, however, did not make to the regulatory agenda either in Basel or in Washington. Nonetheless, they will be analysed in sections 2.12 through 2.14, as they contribute to the history of hedge funds.

2.12 The Internet boom

After the bailout of LTCM and Greenspan's cut of interest rates to stimulate the US economy, US markets – and more generally markets worldwide – experienced a significant boom. Part of the boom materialised in the high valuations of Internet stocks (dot.com companies). From 1998-1999 there was mounting evidence of a boom-and-bust sequence in the New Technology market. Hedge funds were allegedly among the smart players who got people to buy Internet stocks so as to push prices up and then sold short these stocks once the price was deemed high enough (so called bandwagon effect). By selling short they were gaining all the difference between the buying and the selling price, but were also curtailing the valuations of Internet stocks and thus the wealth of ordinary investors. Another thing happened in relation to hedge funds: in March/April 2000, when the bubble started deflating, two among the biggest macro funds, Soros's Quantum and Robertson's Tiger, terminated or converted their hedge fund activity.

On 30 March 2000, the Internet bubble burst. It had been long forecast, at least since late 1998. In 1998, 'dot com' companies – which in general had very few assets and often negative earning prospective – reached a level of market capitalisation not familiar to better established 'old economy' companies. Investors kept buying Internet companies even when

the prospectuses of these companies clearly stated that the firm was not producing earnings and was not expected to produce any in the future. Hedge funds were thought to actively participate in triggering the bandwagon effect, a mechanism similar to the one in place during the conglomerate boom of the 1960s (section 2.9). But at the end of March and at the beginning of April 2000 respectively, two of the most famous hedge fund managers, Robertson and Soros, sent a letter to their investors explaining that their funds were forced to close or reconvert because of the recent frenzy in stock prices. Due to the way hedge funds have been perceived – e.g. always identified with a few leading star managers – this retreat was seen as the end of hedge funds' power.

It is interesting to read the letters that Soros and Tiger wrote to their investors. Both justified their move as a consequence of the 'irrational' turn that the market had taken. As Soros writes,

> Markets have become extremely unstable and historical measures of value at risk no longer apply. Quantum Fund is far too big and its activities too closely watched by the market to be able to operate successfully in this environment [...] [W]e shall convert Quantum Fund into a lower risk/lower reward operation (Soros 2000).

It should be pointed out that hedge funds are said to profit from market volatility and instability; that measures of value at risk have never applied for hedge funds, as they are said to neutralise market risk and convert it into superior returns; and that being closely watched and followed – i.e. herding behaviour – helped Soros make a profit in the conglomerate and REIT booms of the 1960s and 1970s.

Robertson similarly wrote that he could no longer work in a market that lost its rationality. In a letter to his clients, he wrote:

> The key to Tiger's success over the years has been a steady commitment to buying the best stocks and shorting the worst. In a *rational* environment, this strategy functions well. But in an *irrational* market, where earnings and price considerations take a back seat to mouse clicks and momentum, such logic, as we have learned, does not count for much. The current technology, Internet and telecom craze, fuelled by the performance desires of investors, money managers

> and even financial buyers, is unwittingly creating a Ponzi pyramid destined for collapse (Robertson 2000, my italics).

Soros's and Tiger's funds suddenly became the good 'old generation' of hedge fund managers that played *fairly* according to economic fundamentals and disdained market irrationality. Just as it happened in the case of Jones, whose model now is taken as an example of conservative investment, Quantum and Tiger were described as more conservative than the new unscrupulous generation of fund managers. In addition, Robertson and Soros were considered so influential that some commentators even supposed that Tiger involuntarily contributed to the collapse of Internet prices by returning capital to its investors at a time when the market was just waiting for a signal to start selling (Barclay 2000).

Hedge funds, however, were involved in the Internet Bubble for one more reason: according to Jay Ritter, economist at the University of California, banks and hedge funds made business together in the dot.com stocks initial public offering (IPOs) (Ritter 1999; Ritter, interview 2002). According to this account, banks allocated shares to investors, mainly hedge funds, if they promised to trade more of the same shares in the aftermarket. Trading (buying) more of the same shares would increase commissions for banks but also the profit accruing to investors. By trading more of the same shares, in fact, its price would go up and investors would gain all the difference between the IPO price and the selling price. In an SEC-investigated IPO – the initial offering of VA Linux – Credit Suisse First Boston reportedly priced the issue at $30 and at the end of the day the stock was trading at $239. Jay Ritter calculated that over $1 billion could have been gained by selling the shares at the end of that day (*The Economist* 2001). According to *The Economist*, bank underwriters and hedge fund managers, to whom stocks were allocated, might have split the profits. As *The Economist* wrote, 'some hedge funds claim they repaid between one-third and one-half of their profits – though 5-15% may have been more typical – [to banks]' (ibid).

2.13 Speculation in the post-September 11

After September 11 2001, both the financial and non-specialised press repeatedly reported news of hedge funds 'profiteering' from the terrorist attacks and especially from the collapse in the share prices of airlines and insurance companies. The blame was put on the activity of shorting the market. As hedge funds were described as the ones better equipped to sell short, the equation short sellers = hedge funds was an easy one. Articles normally read like this one: 'short selling occurs when an investor, *typically a hedge fund*, borrows stock in order to sell it in the expectation that the share price will fall and it can then be bought back at a lower price...' (Benoit and Boland 2001, my italics; see also Hughes 2001). Emphasis was placed on the huge gains hedge funds could make out of the market distress following September 11. The same article writes: 'a typical hedge fund short selling transaction would net "tens of millions of dollars" in profit on a trade that could be valued at hundreds of millions of dollars' (Benoit and Boland 2001).

Economists and practitioners pointed out that short selling is a common practice for hedge funds, so that they could have shorted those stocks independently of the terrorist attacks. Evidence of analyst reports downgrading airlines earnings before and independently of the attacks was brought forward. As hedge funds buy undervalued shares and sell short overvalued ones, shorting airline companies was part of their strategy (Clow 2001). This is also the explanation given by those hedge funds that openly stated that they made money out of the attacks. The *Wall Street Journal* reports that Pequot Capital Management, which is currently considered to be the biggest hedge fund in the US, 'in the seven trading days since the market reopened [...] made a profit of about $700 million [...]' (Zucherman 2001). The same sources report that it was not the only one.

Discussions followed on the effect and desirability of short selling and calls were made to ban this practice. In order to do short selling, hedge funds have to borrow stocks from

institutional investors or banks. One possibility was to stop or limit the lending of stocks to hedge funds for speculative purposes. 'Some US investment banks are planning to impose restrictions on hedge funds wishing to short vulnerable stocks when the New York Stock Exchange reopens next week', *The Financial Times* wrote on September 15 (Hughes et al. 2001). 'Powerful institutional investors [...] took unprecedented action to curb the frenzied selling of stocks which has sent the London stock market tumbling... the move [...] is designed to make it impossible for speculative investors such as hedge funds to sell shares for short term gains' (Treanor 2001), *The Guardian* wrote on September 25.

These calls and allegations were strenuously criticised in the hedge fund industry. In a letter to various UK newspapers, Albourne Associates, a London-based hedge fund adviser, defined it as an 'outrageous slur on the hedge fund community' (Albourne 2001). More generally, hedge fund managers maintained that banning short selling would have not been desirable. For the purpose of this thesis it is interesting to analyse the reasons that were given to defend the practice. As a hedge fund manager said, '[Banning short selling] would be foolish. It would be taking out a standard and useful practice, *which keeps markets efficient*. It's our job to make the markets more efficient, right?' (Hughes et al. 2001. Quote from Tom Right, manager of Dancing Bear Fund, my italics).

This view was sustained not only in the hedge fund industry, but also among regulators. Regulators in both London and Washington stated that they felt no need to intervene, considering short selling to be beneficial to the market (Hughes et al. 2001). Sir Howard Davies, Chairman of the Financial Services Authority (FSA) in London, said that monetary authorities had no intention to somehow limit the use of short selling and the lending of stocks to short sellers. He said: 'In *normal* circumstances short selling is a natural and important feature of the market. Many would argue it improves "price discovery"' (Hughes 2001, my italics). In addition, Chapters 4 and 5 will show that calls to restrict short selling

by limiting stock lending might be ineffective if banks and other institutional investors are the first to benefit from this business with hedge funds.

2.14 Vulture funds

Among the hedge fund categories described in section 2.5, there is one called 'event-driven' funds. These funds try to take advantage of *events* such as mergers, acquisitions, bankruptcies, reorganisations, distressed debts, and distressed securities. Those event-driven funds that trade on bankruptcies and distressed debt are also called 'vulture investors'. Rosenberg describes vultures in these terms:

> Vultures are so named because they have a predilection for businesses that are dead or dying. Whether a company is in bankruptcy, close to bankruptcy, or heading down a road towards liquidation, it has potential appeal for vultures. Such desperate situations present opportunities to buy stocks, bonds, bank debt, and other obligations at frightening low prices and to collect handsome profits later on when the company distributes assets to creditors and shareholders in its reorganisation or liquidation (Rosenberg 2000: 26).

The beginning of this business is located in the post-Depression years in the US, with the surge in bankruptcy cases after 1929 (Rosenberg 2000: 7). The mode of investing behind vultures is the same as the one behind arbitrage. Their 'modus operandi [is] an arbitrage game of buying the debt of distressed concerns and selling out either at the time of reorganisation or, if stock was the payment, within a few years afterwards' (Rosenberg 2000: vii). In other words, they are a variant of funds like LTCM.

By using these strategies hedge funds operate in the post-crisis scenario (corporate and/or currency crisis) and not only during a crisis. A corporate crisis (bankruptcy) is when a company is forced to sell its assets at a percentage (sometimes 60-50 per cent) of their face value. Hedge funds step in, buy the debt (which is called 'distressed debt') and hope to sell it back later on at something closer to its nominal value. The profit comes from the fact that the company might be forced to sell at unduly depressed prices, but its potential for

recovery is high – e.g. the company is sound overall (Temple 2001: 57). The REIT boom described in section 2.9 provides a good example of vulture investing. The collapse of the real estate market in 1974 caused the bankruptcy of many of these trusts. 'Vulture investors romped in the REITs' bonds some of which had sunk to as low as a tenth of their face value' (Rosenberg 2000: 13). Mainstream economists have emphasised that even in this case hedge funds can act as efficiency-enhancers – 'eagles' instead of vultures – and provide the liquidity to get the company out of bankruptcy. This explanation, however, overlooks the distributive effects of such a move: the company will be on the market again, but at the expense of an enormous transfer of money from the company's stakeholders to vulture funds.

These effects are even clearer in the case of a country's insolvency. A country might be forced to sell its debt at 50 per cent of its face value to avoid bankruptcy or default in its foreign debt. The buyer becomes the owner of the debt and can eventually ask the country to pay it back at its nominal value. This is what happened in 1996 when the New York-based hedge fund Elliott Associates paid in the secondary market $11 million to buy $20 million of Peru's sovereign debt. This means Peru was selling its debt at almost 50 per cent of its face value (Jubilee2000 1999). Later on, the hedge fund sued the Peruvian government for full payment plus capitalised interest. According to Jubilee 2000 Coalition, 'the people involved have carried out similar practices on debt from Panama, Ecuador, Poland, Côte d'Ivoire, Turkmenistan and the Democratic Republic of Congo (ibid). In addition, when a crisis hits a country, corporations and financial institutions are likely to go bankrupt and be subjected to reorganisations, takeovers, and mergers, which provide another ground for event-driven funds to step in. Outside the kind of financial crises analysed in section 2.10 (i.e. East Asian-type of crisis), bankruptcies can also occur as a consequence of a market downturn. The state of affairs after September 11 is an example of market downturn that produced occasions to invest in distressed debt.

Like the Internet Bubble and the post-September 11 speculative attacks, the case of vulture funds did not make it to the FSF regulatory agenda in Basel. This despite the fact that vulture investing can have a significant impact on systemic stability, on the relationship between finance and the real economy and on the distribution of wealth and income across society. According to the theoretical analysis in Chapter 1, the debate on short selling and vulture investing remained at the level of the 'unsaid' in the regulatory discourse on hedge funds.

2.15 Conclusion

This chapter has provided an overview of the theory, practice and history of hedge funds according to the dominant account given in Business Schools and Finance departments. The first part has dealt with their definition, regulatory regime, strategies, number, capital under management, and performance. The second part has dealt with the major market episodes in which hedge funds played a role as either speculators or vulture investors.

A particular representation emerged from that account. Hedge funds have been portrayed as innovative and sophisticated investment vehicles, whose theory of investment is able to outperform the market and more traditional forms of fund management; they are expected to produce higher-than-market returns with lower levels of risk, making them a perfect diversification tool; they are considered to be efficiency-enhancing, as they help prices to go back to their equilibrium level (arbitrage); they are seen as operating outside any regulatory net; they have allegedly participated in the biggest currency crises of the 1990s; they are referred to in any episode of market unrest (September 11); and they are able to create opportunities for smart investing (vulture funds).

The point is not whether this representation corresponds to a clear-cut reality – for many aspects it does not, as in the case of hedge funds' supposed (out)performance or the

importance of manager skills, which are both highly contested (see section 2.8). The point is that this overall representation, even the negative aspects of it (speculation, aggressive trading, etc.), has conveyed the idea that hedge funds are a profitable investment, a win-win strategy, a smart way of playing the market and even an efficiency-enhancing tool. This has made them attractive to investors and untouchable by regulators. The next chapter will challenge this representation and its main arguments.

CHAPTER 3

THE HEDGE FUND DISCOURSE:

Challenging the First Explanatory Model

3.1 Introduction

The previous chapter reviewed the theory, practice and history of hedge funds according to the dominant account given in Business Schools and Finance departments. It argued that it was the overall theorisation of hedge funds rather than the empirical evidence per se that conveyed the idea that hedge funds are a positive aspect of the market and that, therefore, their regulation is unjustified.

This chapter argues that three aspects of this representation or discourse particularly influenced the way in which hedge funds were addressed at the regulatory table: (1) hedge funds as efficiency-enhancing mechanisms; (2) hedge funds as predominantly offshore entities – or entities that can move offshore should regulation be tightened; and (3) hedge funds as different, exceptional or alternative schemes to traditional asset management. When regulators sat at the regulatory table in Basel and Washington, this way of understanding hedge funds had an influence on their choice of policy options and recommendations. But in which way did this representation influence regulators?

Three arguments stemmed from these features of the hedge fund discourse. The first argument is that, if hedge funds are efficiency-enhancing, their regulation is not desirable, as it might hinder their ability to provide efficiency and liquidity to the market. The second argument is that hedge funds would all move offshore (more than they already are) should any tighter regulation be enforced. The third argument is that, if hedge funds are exceptional and different from the rest of the investment community, their impact on the market can

only be minor. These three arguments portrayed the regulation of hedge funds as non-essential.

The three sections that follow analyse and challenge these features of the hedge fund discourse and the arguments that draw upon them. Chapter 5 will then analyse the impact that this representation had on regulatory choices in Basel. It will do so by combining the hedge fund discourse with the regulatory discourse prevailing in the governance of global finance. In other words, Chapter 5 will show how a particular representation of hedge funds and a particular understanding of financial market regulation contributed to leave hedge funds unregulated.

3.2 Hedge funds as efficiency-enhancing mechanisms

3.2.1 The efficiency explanation of hedge funds

This section deals with the first aspect of the hedge fund discourse: hedge funds as efficiency-enhancer mechanisms. It does so by looking at how Finance has explained and theorised them. Given the authority that mainstream finance holds in academic, political and regulatory circles, its explanations hold a legitimating and sometimes a *performative* power, which means that they do not only justify but also 'create' the very reality they want to describe. (On the performativity of Finance see McKenzie 2002 and Clark et al. 2002.) Hedge funds have been explained by three main theories or sets of theories: the Efficient Market Hypothesis (EMH), the Theory of Arbitrage and Behavioural Finance. They all originate from the project of modern finance. Before illustrating each theory, therefore, the main tenets of this project need to be spelt out.

In the early 1950s, neoclassical economics applied to the study of financial markets gave rise to what is now considered to be the beginning of academic finance (modern finance).

This does not mean that there was no academic interest in finance before that time, but that the work done at the University of Chicago in the 1960s and 1970s provided 'a rigorous theory to a large body of empirical results' (Fama 1970: 389). The *rigour* Fama is referring to is the application to finance of the tenets of positivist economics as enunciated by Friedman in its *Methodology of Positive Economics* (Friedman 1953; see also Chapter 1: 29-37). The Efficient Market Hypothesis (EMH), and the Theory of Arbitrage are among the most prominent results of that work. Their most comprehensive enunciation is in the writings of Eugene Fama and Milton Friedman.

These scholars were confronted with a problem of resource allocation. Fama writes: 'The primary role of the capital market is allocation of ownership of the economy's capital stock' (Fama 1970: 1). Given this problem, they theorised how the market could achieve the optimal distribution of that ownership. As Fama writes, 'the ideal is a market in which prices provide accurate signals for resource allocation' (ibid), that is, a market in which prices at 'any time fully reflects all available information' (ibid). Fama called such a market 'efficient'. Moreover, because in this situation market signals appear in the same way to each individual, an efficient market also becomes a 'fair' one. Hence the allocation of the economy's capital stock is optimal.

It is clear that Fama's definition of efficiency is a very specific one, which differs from any common-sense understanding of the word. The Oxford Dictionary defines efficiency in different ways – the fact of being an operative agent or efficient cause; fitness or power to accomplish or success in accomplishing the purpose intended; adequate power, effectiveness, efficacy' (Oxford English Dictionary Online 1989). Efficiency has assumed a variety of meanings in Economics – for instance marginal, economic, or technical efficiency. Markowitz (1952), the founder of modern finance, used it in the engineering sense of 'maximising output relative to input, or minimising input relative to output' (Chancellor: 256). It is in this sense that he referred to an 'efficient portfolio' of stocks.

Fama's usage differs from previous meanings and narrowly refers to the situation in which prices fully reflect all available information. It is the first time that the adjective efficient is used with reference to markets – Markowitz in fact only used it with reference to individual portfolios (Frankfurter and McGoun 1999: 168) – and that becomes synonymous with optimality in the allocation of societal resources. Fama's definition can be said to be 'performative', in the sense that he uploads the word with a new meaning, which in turn synthesises a new explanation of the market.

But which are the conditions that make markets efficient according to Fama? In order for markets to be efficient, investors need to be rational, which in the framework of the theory means that they look at information concerning fundamental values of financial assets in making their investment decisions. The fundamental value of an asset is determined by what the asset will earn in the future. Technically, it is 'the net present value of [an asset's] future cash flows, discounted using its risk characteristics (Shleifer 2000: 2). As much as efficiency, rationality is given a specific meaning – that of looking at fundamental values – which cannot be reduced to its common-sense usage. Once more, Fama's theory is performing and not only describing market reality.

Why is rationality crucial for market efficiency? If investors are rational, they will compete to discover all fundamental information on financial assets and by so doing they will help information to become immediately incorporated within asset prices. This in turn means that prices will only change in response to new information, which is by definition unpredictable. If this is the case, price changes are unpredictable too. As Fama put it, 'in such a world, the only price changes that would occur are those that result from new information. Since there is no reason to expect information to be non-random in appearance, the period-to-period price changes of a stock should be random movements, statistically independent of one another' (Fama 1970: 390).

If prices are unpredictable, no one has privileged information or viewpoint from which to make investment decisions. The contrary – prices are predictable – would be evidence of market inefficiency, as it would mean that information is not immediately incorporated into prices and that some sort of superior information or superior access to information can be exploited. In this situation markets would no longer be fair. The image of the market that the EMH gives is one of a mechanism that quickly processes and digests information and nullifies any speculative move. As an economic textbook writes, 'suppose that stock prices are predictable. What a gold mine this would [be] for investors!' They would all buy the stock whose price is predicted to rise but none would be willing to sell. 'The net effect would be an immediate jump in the stock price [...]. The forecast of a future price increase will lead instead to an immediate price increase' (Bodie et al. 1999: 329).

This not only conveys the idea that the market is an ordered and fair mechanism, but also legitimises the role of speculation. Speculation is herein intended as investors' betting on the direction of price movements. If prices are not predictable, an investor can speculate on their direction, but she only has a fifty percent probability of winning: speculation, therefore, is a fair game of chance. Fama was highly influenced by a treaty on stock markets written by French physician, Luis Bachelier in 1900, which was translated into English only in 1964, exactly during the years in which Fama elaborated his theory. Bachelier's treaty, whose philosophy reflects the physics of the beginning of the XX century, gave Fama's intuition the hard science justification that he was looking for. Bachelier says that in the stock market stock prices are like dust particles, pushed up and down by a mass of individual and independent investors competing with each other to discover new information. Bachelier concludes saying that the expectation of the speculator is zero. 'Obviously a player will have neither advantage nor disadvantage if his total mathematical expectation is zero. Then the game is called a fair game' (Bachelier 1964: 26). Fama was also influenced by another economist, Maurice Kendall, who in 1953 came to the same conclusions as in Bachelier's treaty. After analysing several series of stock prices, Kendall

concluded that the series looked 'like a wandering one, almost as if once a week a Demon of Chance drew a random number from a symmetrical population of fixed dispersion and added it to the current price to determine the next week's price' (Fama 1970: 390). His conclusion, which came to be known as the 'random walk hypothesis' in stock prices, was that no investor is in a privileged position to profit from market opportunities: information is random in appearance and once it appears it is immediately incorporated into investment decisions and then into prices.

Fama also wanted to prove whether his theory stood the test of empirical evidence, given that transaction costs, unavailability of information, and imperfect rationality exist in real world markets. Fama articulates his test by considering three different forms of efficient markets. First, Fama tested whether stock prices are predictable by analysing past price and return histories and called it the *weak form* EMH. Second, Fama tested whether prices are predictable by considering all publicly available information on a given stock or company and called it the *semi-strong form* EMH. Third, he tested whether prices are predictable by using information not yet released to the public, such as insider information, and called it the *strong form* EMH.

According to Fama, all three forms stood up well to the data: 'we shall contend that there is no important evidence against the hypothesis in the weak and semi-strong form tests (i.e. prices seem to efficiently adjust to publicly available information) and only limited evidence against the hypothesis in the strong form tests (i.e., monopolistic access to information about prices does not seem to be a prevalent phenomenon in the investment community)' (Fama 1970: 414). Fama acknowledges that the strong form hypothesis might be difficult to sustain, as it would imply that market specialist have access to the same information as amateur investors. As he writes, 'one would not expect such an extreme model to be an exact description of the world, and it is probably best viewed as a benchmark against which the importance of deviations from market efficiency can be judged' (ibid). Among these

deviations, Fama mentions the case of specialists on major security exchanges, who have monopolistic information on clients' orders, and corporate insiders, who have monopolistic information about their firms. Fama, however, points out that these are exceptions and that overall 'for the purposes of most investors the efficient markets model seems a good first (and second) approximation to reality' (Fama 1970: 416).

Soon after Fama's article (1970), the EMH started being questioned on many grounds and several studies provided arguments and evidence in favour of market inefficiency (Shiller 1984, Summers 1986; Thaler 1993). In a 1991 article in the *Journal of Finance*, Fama himself responded to the critique by recognising that 'market efficiency per se is not testable' (Fama 1991: 1575), but that nevertheless the EMH remains a good approximation of the working of financial markets and that evidence that runs contrary to the EMH has been scant. Despite the now largely acknowledged problems that the EMH presents, it remains the most taught theory in University programmes on financial economics and is still considered the best available tool to explain financial markets.

What does the EMH say about hedge funds? Chapter 2 described how hedge funds bet on the direction of market prices. They can thus be defined as speculators. This section in turn has shown how the EMH justifies the role of speculation. Hence it can be said that the EMH justifies the role of hedge funds.

There is another related theory, however, that not only legitimises speculators, but also assigns them an essential role in bringing market efficiency. This theory, which is largely seen to complement the EMH, is known as the 'Theory of Arbitrage'. Friedman first formulated it in 'The Case for Flexible Exchange Rates', which appeared in his *Essays in Positive Economics* in 1953. In 1965 Fama elaborated the same concepts in his article 'The Behaviour of Stock-Market Prices', published in the *Journal of Business*.

Whereas in the EMH the precondition for markets to be efficient is that investors are rational, the theory of arbitrage says that markets are still efficient even if some investors are irrational. In this case, two things can happen. First, investors are irrational but in an uncorrelated way, so that their trades are random and cancel each other out leaving prices unaltered. The net effect of investors' irrational behaviour is still an efficient market. Second, investors are irrational but this time their trades are correlated, that is, they trade in the same way (which is the case of herding behaviour or, as Fama calls it, 'dependences in price changes', 1965: 37). This means that they all buy or sell assets more than is warranted by economic fundamentals and their trades will not cancel each other out. Even in this case, however, the net effect can still be an efficient market, as irrational investors would be met in the market by 'rational arbitrageurs' (Fama calls them 'sophisticated traders') who, by acting as market contrarians, offset even those correlated irrationalities (Shleifer 2000: 3). Arbitrageurs are not only perfectly rational and able to recognise the fundamental value of an asset, but are also able to correct other investors' irrationality. If a security is under-priced in a market and over-priced in another one (because investors' irrationality drove prices away from their fundamental values), arbitrageurs will sell the expensive asset and buy the cheap one. By so doing, they will earn a net profit for themselves and bring prices in line with their fundamental values in both markets. They make a double service to the community by guiding prices back to fundamental levels and investors back to rationality. Arbitrageurs thus become for the EMH what the invisible hand is for the theory of perfect competition. In this way, speculation is not only a fair game, but is also market stabilising.

The theory of arbitrage is one of the major tenets of modern finance. It is also indicated as the 'Law of One Price' and portrayed as 'the most fundamental valuation principle in finance' (Bodie and Merton 1998: 162). The name comes from the assumption that in a competitive market, if two assets are equivalent, they will tend to have the same price (ibid.). As a textbook example shows, if shares of General Motors (GM) sell at $54 a share on the New York Stock Exchange and $56 on the London Stock exchange, arbitrageurs

would sell shares in London and buy them in New York, as a result making the stock prices in the two locations converge. By so doing, they would 'earn sure profit without investing a penny of [their] own money (ibid. 161). As arbitrageurs compete to discover arbitrage opportunities, these opportunities do not last long and prices quickly converge to their fundamental value. As a consequence, price inefficiencies do not last long either.

Generations of financial economists have been indoctrinated to the advantages of arbitrage. As it was evidenced by a series of interviews with market practitioners and regulators (Brokmeijer, interview 2003, Friedland, interview 2001, Karki, interview 2002, Wooldridge interview 2003), hedge funds have been attributed the role of arbitrageurs according to Friedman' and Fama's definition. This has happened not only with arbitrage or market-neutral funds, but also with global macro funds. Soros, for instance, was said to have brought the sterling pound back to its fundamental value by betting against it in 1992. Macro funds were said to have accelerated the inevitable readjustment in Asia in 1997 (IMF 1998).

This aspect clearly emerges from the IMF paper (1998). In line with Friedman's doctrine, the IMF paper sustains that hedge funds have a role as 'stabilizing speculators', as 'they buy when prices fall and sell when prices rise, which other things equal, should stabilise the markets' (IMF 1998: 11). As their trades run contrary to what the market does, they are said to behave like 'negative feedback traders', which, according to what Chapter 2 said, is a stabilising strategy. Positive feedback traders are instead those traders that buy when the rest of the market is buying and sell when everyone else is selling. For the reasons outlined in Chapter 2 (performance fees, sophisticated investors, longer lock-in period for the money invested in the fund, and so on), hedge funds do not need to follow market trends but can act as stabilisers by doing contrarian trades (IMF 1998).

The political implications of such an explanation are apparent: if speculation is a fair, efficiency-enhancing and stabilising game, why should speculators/arbitrageurs be regulated? They are rational and able to discern the 'real' value of market assets, and by speculating against other investors' irrationality they assure the market remains efficient. Moreover, if irrational investors lose money and rational investors gain it, competitive selection works to clear up the market of the irrational players.

3.2.2 Is the efficiency discourse tenable?

This section challenges the EMH and hence the efficiency explanation of hedge funds. As said before, the EMH started being questioned soon after its formulation and more substantially since the 1980s. The last two decades, in particular, have seen the growth of a huge literature that in various ways undermines the validity of the EMH. The EMH keeps being taught in universities with the premise that 'there is no better alternative', but the debate on its successor is open.

Much of the criticism to the EMH comes from behavioural finance. IPE and economic scholars alike (e.g. Harmes 1998; McGoun and Frankfurter 1999; Keen 2001) have welcomed behavioural finance as a challenge to neoclassical economics and its 'deterministic explanations' (Harmes 1998: 95). For one reason in particular: behavioural finance questions the rationality and efficiency assumptions as exposed by Friedman and Fama. It was music for the political economists' ears to listen to economists finally admitting that markets were inefficient. Behavioural finance, however, partly frustrated these expectations. While there is no doubt that it provides a useful critique of the efficiency explanation and in particular of the theory of arbitrage, as this section will show, it does not fundamentally challenge mainstream finance. It remains anchored to a positivist explanation of the market and suffers from many of the fallacies it wants to correct. Even its explanation of hedge funds, therefore, remains within the mainstream economic mode of problematisation. This section starts by outlining the behavioural critique and will then

conclude that only a political economy approach can challenge the dominant efficiency-based understanding of the market.

With his work on stock market volatility, Robert Schiller is generally considered the founding father of behavioural finance (Schiller 1981; 2000). Many other economists have contributed to the development of its approach (Thaler 1993; Shleifer 2000; and Summers 1986). This section mainly refers to the work of Andrei Shleifer, as he more specifically addresses the role of arbitrageurs/hedge funds in financial markets.

The behavioural critique to the EMH starts with the simple consideration that 'it is difficult to sustain the case that people in general, and investors in particular, are fully rational' (Sheifer 2000: 10). Behavioural finance argues that the EMH is not a *realistic* explanation of how financial markets work. The empirical evidence, financial behaviourists say, contradicts the hypothesis of unpredictability of market prices: prices, they say, are predictable, because markets are inefficient and investors irrational. In particular, behavioural finance questions the EMH assumption that arbitrage can bring prices back to fundamental values. It uses the 'theory of limited arbitrage' and the 'theory of investor sentiment' to explain why arbitrageurs might not work as expected to.

As explained in the first section, the theory of arbitrage rests on the assumption that arbitrageurs can buy the cheaper of two essentially similar securities and simultaneously sell the more expensive one, thus earning a net profit. This implies that there are good substitutes for any security. Behavioural finance points out that 'many securities do not have perfect or even good substitutes' (Shleifer 2000: 24) (*theory of limited arbitrage*) and even when there are good substitutes, prices might take a long time to converge depending on what it calls 'investor sentiment' (*theory of investor sentiment*) (ibid: 11-12). In other words, arbitrageurs are unlikely to perform the role of rational stabilisers as foreseen by the EMH. In this scenario, markets are no longer expected to be efficient and, contrary to the EMH

conclusions, it is possible to make predictions on securities prices. Hence speculation is no longer a fair game.

Let's start with the theory of limited arbitrage. In the case that securities have only imperfect substitutes, if arbitrageurs sell short the overvalued stock and buy the undervalued one, they bear the risk that news on the former will be surprisingly good and news on the latter surprisingly bad – because if these securities are non-perfect substitutes, they are subject to different fundamental news/shocks. The price of the overvalued stock will further raise and the price of the undervalued stock will further drop, thus causing a net loss instead of a net gain. The case of LTCM is exemplary, as its managers bet on the convergence between developed and emerging market asset prices (mainly bonds), thinking of them as perfect substitutes, whereas in 1998 those prices started diverging. As those assets were not perfect substitutes, the Russian debt default affected them in a diametrically opposite way.

Arbitrageurs, however, bear the risk of further mispricing (that is, that the overvalued security gets even more overvalued and the undervalued security even more undervalued) even when securities have perfect substitutes and no news concerning securities' fundamental values is issued. In this case, stock prices are influenced by noise traders' 'sentiment' (theory of investor sentiment). As the theory goes, if noise traders are particularly optimistic/pessimistic about a stock, they might keep on driving up/down its price even without any 'fundamental' reason.

The theory of investor sentiment is at the core of behavioural finance: it argues that investors do not follow any Bayesian rationality but rather a behaviour 'documented by psychological evidence' (Shleifer 2000: 12). With the term 'psychological evidence' behavioural financial economists refer to psychological experiments carried out upon investors, which show how the latter do not behave according to the rationality assumption but instead follow non-rational motives. Two of these motives or drives are said to be

crucial to understand investors' behaviour: *representativeness heuristic* and *conservatism*. *Representativeness heuristic* refers to the situation in which people think that they see patterns in truly random sequences; *conservatism* is when people only slowly update their knowledge in the face of new evidence. Representativeness heuristic leads to overreaction to news. For instance, after a prolonged record of good news about a security investors tend to think that its price will continue on an upward trend and thus tend to overvalue it. Conservatism leads to under-reaction to news, as investors tend to stick to their opinions about a stock and not to update them immediately in the face of new information. Investors' under- and over-reaction to past and publicly available information clearly runs contrary to the weak and semi-strong forms of efficiency, which instead say that this kind of information is immediately and fully incorporated into prices. Investors' under- and over-reaction to past and publicly available news in particular points towards the existence of *momentum* in market prices, that is, of recurrent patterns that make prices predictable. Prices then become predictable because investors' behaviour is predictable.

The predictability of investors' behaviour provides a further reason why arbitrageurs might not be able or willing to bring stability to the market. Shleifer writes: 'Suppose that arbitrageurs know "the model", i.e. exactly the form of behaviour that the noise traders follow, and trade with the noise traders to take advantage of their misperceptions. Would such arbitrageurs bring the price of an asset closer to its fundamental value? At least in principle, it is possible that in some situations it pays arbitrageurs to anticipate future noise trader demand, and to "jump on the bandwagon" when prices are high rather than sell the asset' (Shleifer 2000: 144; Chapter 2: 119). Instead of working as negative feedback traders – as Friedman' and Fama's theory of arbitrage suggests – arbitrageurs might fuel and increase positive feedback trading. Shleifer takes as example the Internet bubble of 2000 and many other financial bubbles documented in the history of finance.

Both the theory of limited arbitrage and the theory of investor sentiment question the role of arbitrageurs in bringing efficiency to the market. In principle, this should undermine the argument that hedge funds are to be left unregulated because of their role as efficiency-enhancers. The behavioural critique, however, has only had a minor impact in both academic and political circles. As it does not fundamentally differ from the mainstream economic perspective, it was easily co-opted into mainstream thinking and did not provide a counter-discourse. The relevance of behavioural finance, however, is to be analysed separately for the theory of limited arbitrage and the theory of investor sentiment.

The theory of limited arbitrage is highly plausible. The argument that there are not perfect substitutes among securities can be sustained by simply observing how many things make two apparently similar securities differ. The example at page 8 (GM shares trading in New York and London) referred to the case of shares of the same company (and therefore in principle identical) trading at different prices in different markets. Even in this extreme case of in-principle identical assets, however, shares are not identical: some of them in fact trade in London and some others in New York. The very fact that the London market opens before New York makes the trade unbalanced and not perfectly hedged. Moreover, arbitrage opportunities are never as straightforward as in the GM example. Most of the time arbitrageurs take as perfect substitute securities issued by different companies in the same or similar sectors, bonds with different maturities, etc. These considerations undermine the very definition and foundation of arbitrage. They also place doubts on Jones's idea of the possibility of a fully hedged investment to which leverage can be applied without fears of increasing the riskness of the operation. The very formula that Jones used to calculate market exposure (section 2.3) could be questioned for the same reason used to problematise arbitrage: there is not a long exposure that is perfectly symmetrical to a short one. The theory of limited arbitrage, however, is not a behavioural finance elaboration. Many practitioners have long been aware of the limitations of arbitrage independently of behavioural finance findings (Airey, interview 2002).

More controversial is the theory of investor sentiment. To start with, behavioural finance economists explain investors' psychology by generally referring to 'psychological evidence'. There are, however, several schools of psychology, which use different methodologies to collect evidence. It can be deduced that what they refer to is the behavioural approach in psychology. As in the other social sciences, behaviourism in psychology is a form of radical positivism, for which the only knowledge that counts is the one based on observable phenomena. A parallel can be made with behaviourism in Politics (e.g. Dahl, Lukes's one-dimensional view of power), which is often questioned for stopping at the surface of phenomena without looking for underlying causes. It is clear that referring to the findings of one psychological approach does not automatically provide the true explanation of how investors behave. The scientific basis behavioural finance is looking for, therefore, is biased from the outset.

A further consideration is that behavioural finance keeps treating investors according to the law of modern finance: the dichotomy smart/dumb money that Shleifer uses (smart are the arbitrageurs and dumb is the mass of investors) does not differ much from Fama's dichotomy rational/irrational investors. The discovery of investor psychology takes the place of rationality in behavioural finance modelling, but the nature of the explanation is the same: it is just another version of the methodological individualism used by the EMH. As much as it is difficult to justify the distinction between rational and irrational investors on the basis of methodological individualistic explanations – that is, only in terms of facts about individuals (Lukes 1977: 178), it is equally difficult to justify the distinction between smart and dumb money solely on the basis of 'psychological laws of behaviour'.

Moreover, a discourse in terms of investors' psychology contributes to an image of financial crises as market pathologies. Market madness, crowd madness, investors' panics, irrational exuberance, are just few of the words that behavioural finance economists use to describe

financial markets.[24] Words such as 'crowd madness', for instance, put the blame on the mass of investors rather than on the elite of speculators. This view inhibits a discourse in terms of power relations and covers the structural constraints that make certain speculators 'dumb' and others 'smart'. Exactly like the EMH, this line of research is utterly instrumental to the interests of the most sophisticated sector of the market population. Its influence on regulatory practices can be rather conservative, as demonstrated by the case of the Internet bubble. Regulators, journalists and practitioners have commented the Internet bubble according to behavioural finance criteria. 'It is not possible to regulate human stupidity', it was said with reference to the high valuations of dot.com shares (e.g. Shleifer 2000: 10; Karki, interview 2002; Warwick 2000, Friedland, interview 2001). In other words, if investors were rational, speculators would not take advantage of them. It is the same explanation that George Soros used to describe his successes in the conglomerate and REIT booms of the 1960s and 1970s respectively (Section 2.9).

To conclude, while the theory of limited arbitrage provides a useful critique to the efficiency paradigm, the theory of investor sentiment rehearses the image of a two-tier market. The efficiency-enhancer and rational investors of Friedman's theory of arbitrage are not too different from the smart investors of behavioural finance. Whereas in the first categorisation arbitrageurs are assigned a useful role in bringing efficiency to the market, in the second categorisation arbitrageurs are somehow justified for their superior skills and the fact of being smarter and not driven by psychological motives. Both theories contribute to make arbitrageurs appreciated rather than blamed and to rule out any consideration about their regulation. Therefore, behavioural finance has not provided a strong opposition to the efficiency-paradigm, which is still the dominant one among regulators, practitioners and most academics and commentators. While in principle opposing the EMH, behavioural finance can be easily co-opted into the mainstream approach, as it does not undermine any

[24] An explanation of financial markets in terms of mass or crow madness is first found in Keynes (1936). See also Kindelberger (1996) [1978].

of its tenets (positivism, individualism). Not surprisingly, behavioural finance has been recently included into mainstream finance textbooks (Bodie et al. 2002). This shows once more that until now Economics has been unable to significantly challenge the efficiency paradigm and provide alternative criteria to evaluate regulatory proposals. Only a political economy approach can do it by introducing issues of power – of 'who gets what, when, how and where'[25] – in the international economy and by bringing in more structuralist explanations of the market.

3.3 The discourse of offshore location

This section deals with the second aspect of the hedge fund discourse and its related argument: hedge funds are mostly located offshore or would all move offshore should a tighter regulation be enforced. According to this argument, any regulatory action targeted at the US or other onshore market could but be ineffective. Alan Greenspan spoke against hedge fund regulation exactly on the grounds that a tighter regulation would drive hedge funds offshore (Committee on Banking and Financial Services 1998; see also Chancellor 1999: 336; and Stonham 1999b: 388). This section shows the main flaws in this argument.

To start with, the idea that most hedge funds are located offshore is contestable. Chapter 2 showed how different vendors provide different estimates of the number of offshore and onshore hedge funds. According to Van Hedge, for instance, the US is the first location for hedge funds both in terms of number and of capital under management. According to Mar/Hedge the US industry accounts for only one third of the total in terms of capital, but remains the largest in terms of number. Though the lack of proper data forbids a clear-cut picture of the geographical distribution of hedge funds, it is nevertheless possible to oppose the argument that hedge funds are mostly offshore.

[25] The so-called 'Laswellian distributive questions' (see Higgott 2002: 44).

Two further distinctions made in Chapter 2 help sustain this point: the first is the distinction between 'domicile' and main 'place of business' and the second is the distinction between 'hedge funds' and 'hedge fund managers'. The first distinction points out that, although offshore funds may be domiciled in the Cayman Islands or Bahamas, they are eventually managed from New York, Greenwich or any other location in the US (and increasingly in the UK and Europe). This distinction has already been made operative in terms of regulation. For instance, a bill introduced in 1999 to revise the US Bankruptcy code (HR 833) uses the distinction between domicile and principal place of business to allow the latter to be the jurisdiction of a main insolvency proceeding of an offshore fund. In the current state of affairs, in fact, the main jurisdiction would be the offshore domicile. This change intends to provide greater protection to investors in hedge funds (banks, mutual funds, etc.). Implicitly, however, it also provides the recognition that managers and investors largely operate from onshore markets and that a regulation can be implemented to target them even when their legal domicile is offshore.

The second distinction points out that the same manager (based in an onshore location, e.g. US, UK, etc.) can administer several offshore funds. In this case, hedge funds can be registered as offshore entities, but in terms of administration they are onshore. In most cases, 'families of funds' or 'funds of funds' are created to group together different funds under the same company umbrella. In this case, a regulatory action targeted at the manager or company umbrella rather than the offshore entities seems even more feasible.

To conclude, these two distinctions show that the argument that hedge funds would all move offshore should a regulation be enforced is untenable. This for the simple reason that it would be extremely difficult to relocate offshore the manager and all the infrastructures that he or she needs in order to operate (banks, financial advisers, lawyers, etc.). In addition, many regulatory measures could be implemented by targeting the fund's manager or

adviser, who most of the time is already registered with an onshore domestic regulatory agency (e.g. with the SEC in the US or the FSA in the UK). Targeting the manager/adviser to promote regulatory measures directed to his/her offshore funds is in principle practicable.

3.4 Hedge funds as 'alternative' investment instruments

This section deals with the last aspect of the hedge fund discourse: hedge funds as different and alternative to the rest of the investment community. The story of hedge funds is told as a story of exceptionality and difference since their inception. It is a story of exceptionality as Jones's model was supposed to provide superior investment returns with lower levels of risk (Caldwell 1995). It is also a story of difference as they are supposed to operate *differently* and in *alternative* to traditional asset classes. While traditional asset managers buy an asset to hold and are fully exposed to the risk of both the asset and the market, Jones's fund was supposed to be hedged against market risk and only exposed to the risk of the asset, which in turn depended on the manager's skills. For this reason hedge funds are also called *alternative investment strategies*.

Whereas the result of considering hedge funds as efficiency-enhancers was to portray them as a positive aspect of the market (section 3.1), the result of singling out a group of actors as 'different' was to brand them as a *niche* phenomenon, whose impact on the market is circumscribed. This section argues that hedge fund strategies are much more widespread than this discourse claims and that the distinction between traditional and alternative investment is an arbitrary one. In particular, the section looks at (1) those instances where investors that are traditionally classified as 'conservative' (e.g. banks, mutual funds) engage in hedge fund-like activities; and (2) those instruments like put-options or single-stock futures that produce the same outcome as hedge funds' strategies.

3.4.1 Banks

The 'counter-argument' of this chapter is that many other financial players can either act as hedge funds or have complex interests and links with the hedge fund industry. Banks are among these players. Other sources (IMF 1998; Eichengreen 1999; Financial Stability Forum 2001 and 2002; Financial Services Authority 2002a; Lowenstein 2001; Temple 2001) mention the relationship between banks and hedge funds, though none of them explores the consequences that this relationship can have on regulation.

Banks are generally classified as conservative investment vehicles. As they collect money from the broader public, it is assumed that their money is prudentially managed – prudentially meaning that banks do not take on excessive risk. Mainstream economics has accustomed us to think of banks as instruments working for the sake of depositors and shareholders and to neutrally execute their clients' orders. This idea is embedded in economic theory as well as in the regulation of advanced markets (Freixas and Rochet 1997).

To challenge this idea this section analyses banks' involvement with hedge funds and the multifarious forms it can assume: (1) banks acting as hedge funds in their proprietary trading desks; (2) entire investment banks being like large hedge funds; (3) commercial banks acting as investment banks and having their hedge fund business; (4) banks as educational ground for hedge fund managers; (5) banks as credit providers to hedge funds (normal lending activity); (6) banks as prime brokers providing financial services such as securities lending, contracts for difference, reverse repurchase agreements, and OTC derivative contracts ('secondary' lending); (7) banks acquiring and/or setting up their own hedge funds and expanding their private banking operations so as to offer investment in hedge funds to institutions, high-net-worth/affluent individuals and even retail investors.

Proprietary trading or arbitrage desks (PTDs) can be described as the *inter alias* of hedge funds. In principle, only investment banks should have proprietary trading/arbitrage desks, but in the last decade commercial banks have expanded into a whole new array of activities so that 'now any large money centre bank worth its salt owns an investment bank' (Temple 2001: 158). For US banks, the demise of the Glass-Steagall Act in 1999 meant the dismantling of the barrier between investment banks on the one hand and commercial and more consumer-oriented banks on the other and the creation of giant firms like JP Morgan-Chase and Citigroup. In Europe and Japan, in contrast, the universal-type of bank has always been the dominant model.

Technically, proprietary trading is the bank's trading for its own account, that is, the bank's trading with the funds it collects from depositors and shareholders. In this business banks behave exactly like hedge funds: they can use short selling and leverage, arbitrage and derivatives, and can trade in any market – currencies, equities, debt, commodities, etc. Even in terms of regulation they are not much more regulated and transparent than hedge funds are (see Chapter 5).

In addition, studies on banks' proprietary trading desks are lacking and collecting information on them is nowhere easier than collecting data on hedge funds. As Subir Lall – economist with the IMF Global Markets Division – confirmed, detailed information on arbitrage desks is not available (Lall, interview May 2002). Contrary to the growing literature on hedge funds, not much is known about the activities and the people working in banks' proprietary desks. 'We know the names of the famous [...] hedge fund managers, but proprietary traders at leading banks are anonymous figures' (Temple 2001: 153). PTDs, however, have been around for much longer than hedge funds and have always provided a training ground for hedge fund managers.

Banks do not report clear data on proprietary trading activities (Anonymous 18, interview 2002). This makes it very difficult to assess the extent of this business. Among the banks surveyed – Deutsche Bank, Goldman Sachs, Morgan Stanley, Citigroup, Barclays, Salomon Smith Barney – only Deutsche Bank breaks down data on proprietary trading.[26] In Deutsche Bank 2001 20-F document (a filing requirement with the SEC), proprietary trading is reported under the name 'designated proprietary trading' within the Corporate and Investment Bank Group Division.[27] Table 3.1 reports data on PTD activity as it appears in Form 20-F (Gade, interview 2002). The first column reports *net revenues* from the bank's designated proprietary trading (Deutsche Bank Form 20-F 2002: 34), while the second column reports the bank's *overall trading performance* (ibid: 121). To arrive at a figure of designated proprietary trading as a percentage of total trading revenues, it is enough to divide column one by column two: the results for 1999, 2000 and 2001 are reported in column three.

Table 3.1 Deutsche Bank proprietary trading activity (millions of €)

	Net revenues from DPT (Millions of €)	Overall trading performance (Millions of €)	Share of DPT (%)
2001	575	7,416	7.75
2000	594	7,486	7.93
1999	553	4,031	13.72
1998	(65.8)*	-	-
1997	-	-	-

Source: Deutsche Bank Form 20-F 2002: p. 34 (DPT) and 121 (trading performance).
* Numbers in brackets indicate a negative amount. Data for 1998 are collected from Form 20-F: September 2001.

Yet this gives figures only on *gains* from PTDs, but not on the overall *capital allocated* to proprietary trading. Even the percentage of DPT is a share of revenues and not of capital

[26] The choice of these five banks stems from the idea of having a sample of both investment and commercial banks and European as well as US banks.
[27] The Corporate and Investment Bank Group Division includes two corporate divisions, each of which has three business divisions. The Corporate Banking and Securities Corporate Division includes Global Markets, Global Equities, and Global Corporate Finance. The Global Transaction Banking Corporate Division includes Global Securities Services, Global Cash Management, and Global Trade Finance. Designated proprietary trading is accounted within the divisions Global Markets and Global Equities.

under management. Despite these limitations, a few considerations can be made. In 1998, the year of the emerging market turmoil, the bank registered a net loss of €65.8 million (Deutsche Bank Form 20-F 2001: 36). Form 20-F 2001 also reports that the Emerging Markets Proprietary Trading Unit was closed in 1998. As the form says, 'between 1998 and 2000, we substantially reduced our proprietary trading in emerging markets securities by closing our Emerging Markets Proprietary Trading unit' (ibid). If Deutsche bank can be seen as a representative case, these data confirm that banks were as involved as hedge funds in the arbitrage gains that brought down LTCM.

Table 3.1 confirms that the whole Bank's proprietary trading has shrunk since 1998. Does it mean that the Bank has given up this business? To answer this question it is necessary to consider the Bank's overall policy. The fact that Deutsche Bank has reduced or closed down part of its designated proprietary trading does not mean that it is getting out of the hedge fund business. On the contrary, since 1998 Deutsche Bank has become more and not less involved in a hedge fund mode of trading and investing (this chapter, page 162).

A broader analogy needs to be made beyond the strict comparison between hedge funds and proprietary trading desks. As a manager at Morgan Stanley said, 'in some respects, an investment bank is like a big hedge fund in its own right. This means that instead of comparing hedge funds with proprietary trading desks, *hedge funds should be compared with the whole investment bank*' (Altham, interview 2002, my italics). Though the manager at Morgan Stanley alludes to the case of investment banks, most commercial banks have an investment banking division too, so that what follows applies to both commercial and investment banks.

To begin with, proprietary trading activities are carried out outside the narrowly defined 'bank's trading for its own account' and include a bank's trading for client accounts and

client orders. As Temple points out, 'even outside proprietary trading a bank is nevertheless going to trade currencies, equities and fixed income: this is not normally called proprietary trading, but that's what it is' (Temple, interview 2002). The above-mentioned Deutsche Bank report strengthens this point:

> Most of our trading activity is *ancillary to customer transaction*. For example, in order to facilitate customer flow business, traders ordinarily maintain long positions (accumulating securities) and short positions (selling securities we do not yet own) in a range of securities, minimising our exposure by hedging transactions when appropriate. Under such circumstances, we cannot avoid putting the bank's capital at risk, but *we do not view this* as proprietary trading. However, there are situations where *we choose to* put the bank's capital at risk; this is what we term proprietary trading (Deutsche Bank Form 20-F 2002: 34, my italics).

The same can be said for the other banks surveyed, especially for investment banks. Goldman Sachs and Morgan Stanley Annual Reports explicitly say that proprietary trading is intended as the trading for both the bank' *and* customers' accounts. In the case of Goldman Sachs, proprietary trading takes place within the division of Trading and Principal Investment, where the Bank 'facilitates customer transactions *and* takes proprietary positions (Goldman Sachs Annual Report 2001: 7, my italics). In the case of Morgan Stanley, proprietary trading is carried out within the 'Securities' segment, where the bank executes 'sales, trading, financing and market-making activities to facilitate client orders *and* on a proprietary basis...' (Morgan Stanley Form 10-K 2001: 2, my italics). The 'integrated' nature of the two activities is stressed in the 'Notes to Consolidated Financial Statements', where the bank's trading activities are said to be 'conducted through the *integrated* management of its client-driven and proprietary transactions...' (ibid: 84, my italics; see also Anonymous 18, interview 2002).

An investment bank is like a hedge fund also for another reason. In addition to proprietary trading activities broadly conceived, investment banks (or investment arms of commercial banks) manage clients' money through in-house hedge funds and/or keep clients' assets in third-party or satellite hedge funds. This activity is usually carried out in the 'Asset Management' or 'Investment Management' division of the bank. Though it is not possible

to know exactly which share of total assets is managed through hedge fund strategies, various elements suggest that this is where banks are increasingly getting involved in the hedge fund industry. A first element is banks' growing acquisition of satellite hedge funds or launch of new ones.

In 1997 Goldman Sachs Group acquired a fund of funds manager – Commodities Corp. Ltd. – from Stockton Holdings, later renamed 'Goldman Sachs Princeton'. In 2002 the fund reportedly managed $4 billion (Barr 2002), which is the size of a large hedge fund (Chapter 2: 86-94). In March 2001 Goldman Sachs International launched an offshore fund of funds aimed at U.K. and European institutions, called the 'Goldman Sachs Global Market Independent Partners fund' (Barr 2001b). As for Morgan Stanley, in March 2000 the Bank announced the creation of 'Morgan Stanley Dean Witter Alternative Investment Partners', a partnership between the pension fund management team of Weyerhaeuser Corp and Morgan Stanley. The purpose of Morgan Stanley was to use Weyerhaeuser's capabilities in the hedge fund and in general alternative investment business to boost its expertise in this area. The same group already manages a similar fund, 'Morgan Stanley Liquid Markets Fund I LP' (Barr 2001c). Finally, in December 1999 Morgan Stanley announced the acquisition of Graystone Partners LP, a consulting firm specialising in alternative investments for high-net-worth individuals. According to Hedge World, Graystone 'has relationships with more than 70 hedge fund managers [and] currently manages approximately $3 billion for families who have more than $100 million in assets' (Hedge World 1999; Morgan Stanley 1999). This is evidently a move to introduce hedge funds into the Private Wealth Management Division of the Bank and by so doing commercialise hedge funds to the Bank's affluent ($100,000 minimum investment) and not only high-net-worth ($1 million minimum investment) clients.

A further aspect is that banks like Morgan Stanley and Goldman Sachs are not only able to trade *like* hedge funds, but also *for* hedge funds. In addition to proprietary trading and asset

management, banks play an additional role by providing hedge funds with credit and by entering into various contractual commitments, such as in the OTC derivative markets, whose ultimate purpose is to provide hedge funds with credit and leverage. Banks provide all these financial services in their quality of *prime brokers*.

First, banks lend money to hedge funds. 'No hedge fund could borrow as cheaply as Morgan Stanley, Merrill Lynch, Goldman Sachs...' (Forbes 1998). So bank-prime brokers borrow money and re-lend it to hedge funds charging between 0.0075 and 0.015 per cent over its own borrowing costs. If a bank lends $100 million to a hedge fund and charges 150 basis points, it gets back $1,5 million in fees (ibid.).

Credit to hedge funds, however, only rarely takes the form of commercial lending and more often consists of *securities lending*. As Christopher Airey of Old Mutual Securities points out, 'investment banks are a major (if not *the* major) provider of debt to hedge funds through their securities operations, *not* through their commercial lending arms' (Airey, interview August 2002). Securities lending is a way to increase a fund's leverage, so that it is possible to say that 'leverage in the securities markets is acquired in ways other than straightforward borrowing' (Temple 2001: 100).

What does securities lending consist of? Securities lending is a margin transaction. It means that banks lend securities to hedge funds in exchange for a collateral (margin). The amount of the collateral depends on the bank's *own* valuation of the soundness of the counterparty. In the case of LTCM, banks set the level of collaterals very low, which is why LTCM leverage was high. Banks do not generally own the securities, but act as intermediaries between the owners/lenders of the securities and the borrowing hedge funds. Many times the owners do not have any knowledge of their stocks being lent to hedge funds nor of the fact that the same securities can be lent more than once at a time (see repo agreements below). As hedge funds borrow securities with the purpose of selling them short, this may

result in the value of the securities being curtailed (Temple 2001:164-168), which in the last instance will damage the rights of the stockholders.

Securities lending gets particularly complex with the use of 'repurchase agreements' (repo agreement) and 'contracts for difference' (CFDs). Repurchase agreements 'involv[e] the sale of a security to a counterparty with an agreement to repurchase it at a fixed price on an established future date' (FED Trading Manual 2002). The security serves as collateral against the obligation of the borrower and does not become the property of the lender (ibid). The same securities can be used as collateral for several different transactions at the same time. This clearly 'creates the capability for a double dose of leverage' (Temple 2001: 100). There are two control measures banks can exercise: 'haircuts', which means that the financing bank asks to post additional collateral; and 'hypothecation', which means that the asset/bond that is repoed cannot be used in another transaction with a different counterparty. Both measures were inactive in the case of LTCM's trades (Temple 2001: 101). Without taking the extreme case of LTCM, the possibility that the same securities can be lent more than once at a time is described as common practice in the last Morgan Stanley Annual Report (2001): 'reverse repurchase and repurchase agreements and securities borrowed and securities loaned transactions may be entered into with different customers using the same underlying securities [...]' (Morgan Stanley Form 10-K 2001: 32).

Another sophistication of securities lending is the contract for difference (CFD), which is an agreement to exchange at the closing of the contract the difference between the initial and the final price of an equity multiplied by the number of equities in the contract (Newman 2002). Like repo agreements, CFDs are margin transactions. This means that the trader does not have to put up the full underlying contract value, but only a margin from as little as 10 or 5 per cent of the contract value (which means that their leverage will be 10:1 or 20:1). Finally, banks can grant credit to hedge funds by entering into derivative contracts (most of the time OTC derivatives). Derivative contracts are again margin – and hence leverage

enhancing – transactions, where the buyers or sellers get exposure to the underlying securities without committing the entire capital needed to own them.

The concrete effect of these instruments is to increase leverage for hedge funds and profits for banks. This is because hedge funds need to borrow securities in order to do short selling (see Chapter 2: 71). The bank that lends them the securities earns an interest on the proceeds of the short selling, trading and clearing commissions, and income from derivative transactions. As hedge funds are heavy short sellers, the more they short, the more banks find business with them profitable (Forbes 1998). It is clear from their annual reports that the provision of prime brokerage services is becoming the single most important source of revenues from banks' business with hedge funds. As a hedge fund consultant remarked, 'banks' role in the hedge fund industry is increasingly that of trading counterparties in derivative transactions and of securities lenders' (Nagata, interview 2001).

Three banks rank first in this business. According to a survey by Hedge World, Morgan Stanley, Goldman Sachs and Bear Stearns as the three largest prime brokers for the hedge fund industry (Gallo 2001d). Morgan Stanley Prime Brokerage services 210 of the 998 funds polled for a total of $32.6 billion in assets, Bear Steam Securities Corp. services 187 funds with $22.3 billion in assets and Goldman Sachs & Co. ranks third with 143 funds and $15.6 billion in assets.[28] Morgan Stanley also ranks first in servicing the largest hedge funds, the ones with more than $1 billion in assets (Gallo 2001d; Morgan Stanley 2001b).

Quantifying this activity, however, is no easier than quantifying proprietary trading. No bank or financial house, according to Forbes, 'breaks out revenues derived from dealing with hedge funds. It is most buried in items like net interest income' (Forbes 1998) or securities services and fees. Despite these limitations, few considerations can be made. The case of Morgan Stanley and Goldman Sachs are herein considered. In 2001 Goldman Sachs

reported $1.13 billion net revenues from securities services, which mainly consists of prime brokerage services and securities lending. This accounts for more than a 20 percent increase over 2000 and a 46 percent increase over 1999 (Table 3.2).

Table 3.2. Goldman Sachs net revenues from core business (in millions of $)

CORE BUSINESS	2001	2000	1999	1998(1)	1997(2)
Global Capital Markets					
Investment Banking	3,836	5,371	4,359	3,368	2,587
Trading and Principal Investment:	**6,349**	**6,627**	**5,773**	**2,379**	**2,926**
• FICC	4,047	3,004	2,862	1,438	2,055
• **Equities**	**2,923**	**3,489**	**1,961**	**795**	**573**
• **Principal Investment**	**(621) ***	**134**	**950**	**146**	**298**
Total Global Capital Markets	10,185	11,998	10,132	5,747	5,513
Asset Management and Securities Services					
• Asset Management	1,473	1,345	919	675	458
• Securities Services	1,133	940	772	730	487
• Commissions	3,020	2,307	1,522	1,368	989
Total Asset Management and Sec. Services	5,626	4,592	3,213	2,773	1,934
Total Core Business	**15,811**	16,590	13,345	8,520	7,447

Source: Goldman Sachs Annual Report 2001: 28-31
(1) Data for 1998 in Annual Report 2000: 30-34;
(2) Data for 1997 in Annual Report 1999: 28-32
*Numbers in brackets indicate a negative amount

Forbes reports that Michael Steinhardt, the legendary hedge fund manager who used to work with George Soros, 'traded as much as 1 billion shares a year and at his peak generated some 60 million dollars in commission revenue alone for Street firms, including Goldman' (Forbes 1998). Forbes also notices how 'for the six months through August 1998 Goldman's revenues from securities services increased 45 per cent over 1997' and estimates that most of this increase came from hedge funds (ibid). In contrast, Goldman Sachs's 1998 revenues from principal investment (a proxy for proprietary trading) decreased by 50 per cent over 1997 (Table 3.2). This means that prime brokerage remained profitable even when the arbitrage and macro-fund trading in the proprietary desks suffered heavy losses. The same goes for Morgan Stanley: its 2001 *net interest* revenues, which are a good proxy for revenues from prime brokerage, increased by 20 per cent over 1997 (Table 3.5).

[28] Merrill Lynch occupies the fourth position with $ 6.5 billion in assets.

Table 3.5 Morgan Stanley 'net interest' revenues

(Millions of dollar)	2001	2000	1999	1998	1997
Total revenues	43,727	44,985	34,587	30,669	26,808
Interest and dividends	24,127	21,234	14,880	16,385	13,583
- Interest expense =	20,779	18,176	12,515	13,463	10,806
Net interest	3,348	3,058	2,365	2,922	2,777
Other	520	485	244	284	144

Sources: Morgan Stanley Annual Report on Form 10-K 2001: 20.

By providing these services, banks' prime brokerage divisions know how, when and where their clients trade. This information can leak to banks' investment banking or proprietary trading departments, though in principle this instantiates a conflict of interest. 'Prime brokerage is supposed to be segregated from the rest of the bank, though this is a rule of confidentiality and not a strict regulation' (Anonymous 19, interview 2001). In addition to commission fees, banks can thus profit from their dealing with hedge funds. In order to prevent it, hedge funds do not generally rely on only one prime broker but use several different ones (Anonymous 20, interview 2002). It is difficult to say, however, whether hedge funds succeed in keeping their positions secret. In the case of LTCM, banks' proprietary desks were aware of its trading and mimicked them to enjoy as high profits as LTCM did (Lowenstein 2001; Dunbar 2000). When the fund got into troubles this knowledge reportedly made things worse. 'Banks had a partial insight into these trades either because they executed them (prime brokerage) or because they lent money to LTCM (commercial lending). When LTCM ran out of money, banks would have had to lose money simultaneously, with the addition that investment banks' positions were much larger than LTCM's ones' (Temple, interview 2002).

What described for investment banks also applies to more consumer-oriented or retail kind of banks, such as Citigroup or Barclays. Citigroup is the American financial giant born from the merging of Citicorp and Travelers group in 1998. Its operations extend to nearly any financial market. Plus, it has subsidiaries in the mutual fund and insurance industries

(Citigroup 2003a). It ranks first among the top 1000 commercial banks listed annually by The Banker (The Banker 2002). Officials at the FED in Washington take Citigroup as example of a more consumer-oriented and conservative type of banks (Siddique and Garza, interviews 2002). This, however, did not prevent Citigroup from accumulating large interests in the hedge fund industry.

Citigroup's proprietary trading activities might be minor in relation to the overall business of the bank[29] (Table 3.6) and they have certainly shrunk since mid-1990. However, Citigroup owns Salomon Smith Barney, which is a Goldman Sachs-type of investment bank. In addition, since 1991 Citigroup have operated a hedge fund service that, including other alternative investment strategies, has capital under management of around $70 billion (Citigroup 2003b). In August 2002, Citigroup set up a fund of funds, Citigroup Alternative Investments Multi-Adviser Hedge Fund Portfolios Llc., and located it in Greenwich, the traditional domicile for US hedge funds. As a fund of funds, Citigroup Alternative Investments Multi-Adviser Hedge Fund Portfolios has the adviser registered with the US regulatory authority (SEC) but the capital invested in several non-registered and anonymous hedge funds located offshore (Gallo 2002c). Citigroup and Salomon Smith Barney are also providers of credit and financial services (brokerage, derivative contracts and so on) to hedge funds.

Table 3.7 shows changes in Citigroup's asset management by product and by client. The classification by product shows that alternative investment strategies grew from $27.2 billion in 1998 to $39.4 billion in 2001 – an increase of nearly 31 per cent. Over the same period of time, total assets under management grew by only 18 per cent. This not only means that most of the growth in the asset management segment

[29] The total revenues of the CItigroup amounted to $112,022 million in 2001 ($83,625 net of interest expenses), while proprietary trading activities in the same year accounted for less than $4,000 million.

is attributable to alternative investment strategies, but also that their growth has more than compensated a drop in other asset classes, such as retail assets (see both classification by product and by client). This is quite significant for a bank that is considered to be a consumer-type of bank and fairly conservative in its strategies.

Table 3.6 Citigroup: proxies for proprietary trading activity (revenues in millions of $)

	2001	2000	1999	1998
Total Corporate and Investment Bank (1)	14,397	15,945	12,900	8,534
Commissions and Fees	3,702	4,471	3,721	3,359
Asset Management and Administration Fees	2,035	2,169	1,641	1,326
Investment banking	4,519	4,098	3,353	2,555
(of which) **Proprietary Investments (2)**	380	2,042	800	743
Principal Transactions	3,248	4,238	3,609	597
Other income	893	969	576	697

Source: data from Citigroup 2002.
(1) Total non-interest revenues, which means excluding net interest and dividends.
(2) Includes Venture Capital Activities and certain other corporate investments.

Table 3.7 Citigroup: changes in assets under management by product and by client

Assets under management by product type (billions of $)	**2001**	**2000**	**1999**	**1998**
Retail	66.7	90.6	77.5	70.0
Institutional	53.3	23.9	19.3	13.7
Total money market and institutional liquidity funds	120.0	114.5	96.8	83.7
Long-term mutual funds (total)	89.1	83.1	83.1	81.7
• Equity/Balanced	52.3	53.8	51.5	42.0
• Taxable Fixed Income	18.9	14.4	18.1	25.2
• Tax Exempt Fixed Income	11.2	8.9	8.8	10.8
• Annuities	6.7	6.0	5.4	3.7
Managed accounts				
• Private client	66.7	61.2	51.1	40.4
• Institutional	89.9	91.7	100.0	94.0
• Emerging markets pension administration	5.0	4.0	-	-
Unit Investment Trusts	6.9	9.4	12.9	12.9
Alternative Investment Strategies	39.4	35.8	32.7	27.2
Total assets under management	416.9	399.7	377.3	339.9
Assets under management by client type (billions of dollar)	**2001**	**2000**	**1999**	**1998**
• Retail	227.3	242.2	222.6	202.1
• Emerging Markets pension administration	5.0	4.0	-	-
• Institutional (including alternative investment strategies)	184.6	153.5	154.7	137.8
Total assets under management	416.9	399.7	377.3	339.9

Source: Citigroup 2002.

Salmon Smith Barney includes a large component of alternative investment. The 'Private Capital Group' (PCG), which was founded in 1998, held approximately $4 billion in client assets under management at the end of 2001 (the size of a large hedge fund). Part of this capital was invested in hedge funds and the rest in other alternative investment strategies, such as venture capital, mezzanine funds, and buyouts (Salomon Smith Barney 2002a). Another Bank's group, the 'Consulting Group', also uses hedge fund strategies to manage its client assets. At the end of March 2002, the Consulting Group overall 'managed client assets totalling 243.9 billion for over 697,297 accounts representing corporate and pension funds, insurance companies, endowments and high-net-worth individuals' (Salomon Smith Barney 2002b and 2002c). As in previous cases, it is not possible to calculate the percentage of assets that is managed through hedge fund strategies. However, given the large space that it is devoted to it in the Bank's reports, it can be said that the strategy is rapidly growing in importance (Salomon Smith Barney Consulting Group 2001).[30]

The acquisition or launch of hedge funds has become a common trend in the banking industry. A striking example is that of Deutsche Bank, which has launched several hedge funds in the US and Europe since 1999 (Hedge World 2000b). After the launch of three hedge funds in the US, in 2000 Deutsche Bank launched a fund of funds for the European market, 'Xavex HedgeSelect', which invests in more than 20 individual hedge funds and is targeted at the affluent market – minimum investment €100,000 (Gallo 2000b). In 2000, Deutsche Bank launched a market-neutral hedge fund for UK institutional investors, 'Equilibria Hedge Fund' (Hopfinger 2000). In early 2001, it launched 'Xavex HedgeFirst', 'the first ISA approved retail-oriented hedge fund product available to investors in the United Kingdom' (Gallo 2001a). In September 2001, he signed an agreement with Zurich Scudder, which would allow Deutsche Bank to access Zurich's private banking channel to

commercialise its hedge fund products. Finally, in September 2002, Deutsche Bank Absolute Return Strategies, the global hedge fund management business of Deutsche Bank, launched a fund of hedge funds, 'DB Hedge Strategies Fund LLC'. This fund would allow investors to put money into a single portfolio of 25 to 40 individual hedge funds (Merrill Lynch 2002). These hedge funds have been targeted to different classes of investors: apart from high-net-worth individuals, Deutsche Bank targeted the affluent segment (€100,000 minimum initial investment in its European funds) and even the retail segment (ISA accounts, maximum 7,000 pound in the UK-commercialised funds).

As said before, Deutsche Bank is an example of how banks have become more and not less involved in hedge funds since the crises of 1997 and 1998 and the collapse of LTCM. It also shows that this happened not through a strengthening of arbitrage desks but on the contrary through dismantling or reducing these desks and relocating the same activities to external funds. As the Deutsche Bank 2001 Annual Report reads, 'we manage our investments in hedge funds as principal in the Private Clients and Asset Management Group Division and *on a smaller scale* in the Corporate and Investment Bank Group Division' (Deutsche Bank Results 2001 Annual Report: 187, my italics). As this last statement reveals, new hedge funds are generally created out of the asset management capabilities of investment and commercial banks. Barclays Global Investor, the asset management arm of Barclays Bank, provides another example of it. In October 2000, Barclays Capital launched its first hedge fund, the 'Barclays Global Investors UK Equity Market Neutral Fund', and in April 2001 a second European hedge fund, the 'Ascent Asset Allocation Fund' (Barr 2001a).[31]

Why did banks increase their allocations to hedge funds? According to Peter Temple, hedge funds have represented a response to the market downturn of the last three years (2000,

[30] See for instance, the 3rd Quarter 2001 Report, which opens with the description of the Multi-Strategy Market Neutral Investments (a hedge fund created by the Consulting Group) and defined it as a 'port in the storm'.
[31] A list of banks that have launched hedge funds can be found at www.hedgeworld.com.

2001 and 2002). 'After the Internet bubble of 2000, mutual funds and banks were shattered and they had to find a way to get decent returns. The flight to quality meant investing in bonds and away from equity and emerging markets, but it also meant a flight to hedge funds' (Temple, interview 2002). As hedge funds are able to sell short, they are assumed to gain positive returns in any market situation, even (and sometimes better) during a market downturn.

Banks started launching new hedge funds in the aftermath of the Asian crisis. In 1998 banks got scared at the extent of their proprietary trading desks' exposures. They started scaling down their operations in 'internal' hedge funds and moving them outside. This, however, has left their interests untouched. In the case of Salomon Smith Barney, for instance, the same individuals are still trading as they did before, though this time as a third party. This assures that if something goes wrong, the bank will incur no visibility and exposure risk (Temple, interview 2002). Externalising PTDs activities was perceived as a clever way to get rid of any 'reputational risk'. In this way, in fact, hedge funds remain the only identifiable part of the business, while banks remain unidentifiable (ibid). This is why it is not surprising that the accusation of currency manipulation that hedge funds were moved in 1997 and the collapse of LTCM in 1998 did not stop but quite the opposite triggered the mushrooming of hedge funds. Many observers notice that it was not new money flowing into or creating new hedge funds, but mainly money coming out of banks' PTDs (Anonymous 20, interview 2002).

Guy Ingram of Albourne Associates – a London-based hedge fund consultant – draws attention to another reason. He says that banks are 90 per cent more profitable if they offer their financial services to an external hedge fund rather than running in-house proprietary desks. In this case in fact, the profit (uncertain) of the hedge fund becomes fees income (certain) for the bank' (Ingram, interview 2001). A final reason is that star managers can get a far better income if they go and work for a hedge fund than if they stay in a bank. As a

result, banks had to open their own hedge funds to prevent their brightest managers from leaving or rival other banks and asset management firms that were already doing so (Gallo 2001b).

The last aspect of banks' involvement with hedge funds is that banks have always been the educational ground for hedge fund managers. To start with, the *curriculum vitae* of hedge fund managers shows that they usually come from a career in the arbitrage desks of banks such as Goldman Sacks or Salomon Smith Barney (Karki, interview 2002; Nagata, interview 2001). 'Many traders walked out of these banks and created their own hedge fund, but it is there that they learnt their job' (Karki, interview 2002). Lately, banks have started another education effort by sponsoring initiatives to study and promote a hedge fund mode of investing. Banks' money has been increasingly used to sponsor initiatives aimed at bringing together hedge fund managers and potential investors. They have organised conferences, workshops, golf tournaments and have sponsored research centres on hedge funds. For instance, sponsors of the London Business School newly created 'Centre on Hedge Fund Research' are Deutsche Bank, Merrill Lynch; Bank of Bermuda; BNP Paribas; Fauchier Partners Ltd and Prudential-Bache International Ltd. Four of them are banks; one is an international investment and brokerage services provider and only one, Fauchier Partners, is an adviser to and manager of hedge funds and funds of hedge funds. The 9th MAR conference on hedge fund investment, which took place in Southampton Princess Bermuda in October 2002, had among its sponsors: Asset Alliace, Bank of America Securities, Bank of Bermuda, Merrill Lynch; Salomon Smith Barney/Citigroup Global Prime Brokerage; UBS Warburg, BankBoston Brazil – Brokerage Company (Mar/Hedge 2002). These are further reasons to disregard the claim of difference.

To conclude, hedge funds should be seen as a product of banks rather than an alternative to them. As Jorge Guira, lecturer in Corporate Finance at the University of Warwick, points out, 'even before 1949, when the first hedge fund was created, there were partnerships

intended as organised mechanisms created by banks to give money in a confidential way. Hedge funds are the logical consequence of banks: as there are a number of deals that banks cannot do in-house, they need private partnerships outside regulatory oversight' (Guira, interview 2002). The considerations made in this section will be useful when discussing the regulation of hedge funds and the role that regulators in both Basel and Washington assigned to banks in 'indirectly' supervising hedge funds (see the discussion on indirect regulation in Chapter 5). The delegation of supervisory functions to banks might be misplaced if banks have so many interests in the hedge fund industry. Banks may decide to join rather than fighting hedge funds. This would undermine the 'indirect regulation' approach privileged in Basel.

3.4.2 Mutual funds

In the financial and legal literature hedge funds are defined in opposition to regulated investment companies – i.e. mutual funds. The case of the US regulation is herein considered. A similar legislation is in place in other advanced markets.

Chapter 2 explained that hedge funds were created out of a loophole in the US Investment Company and Securities regulations and that the reasons that make hedge funds unregulated are the same that impose regulation upon mutual funds. Chapter 2 also reminded that the regulation of mutual funds consists of a series of measures restricting, among other things, the use of leverage in general and the short sale of securities in particular. According to § 12 (a) of the Investment Company Act,

> [*It*] *shall be unlawful for any registered company*, in contravention of such rules and regulations or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors [...] *to purchase any security on margin [and]... to effect a short sale of any security* (Investment Company Act of 1940, my italics).

This forbids mutual funds from using one major feature of hedge fund investment: the possibility of selling short, which in turn requires the fund to be able to purchase on margin.

The rationale behind this ban is to prevent mutual funds from assuming too speculative a character. The same purpose is behind another provision under section § 18 (f) of the 1940 Act that prevents mutual funds (and registered investment companies in general) from issuing so called *senior securities*. Senior security 'means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness' (§ 18 (g) of the 1940 Act). Forbidding the issuance of senior securities once again means forbidding the use of leverage.

The aim of this section is to show that, despite the provisions of the Investment Company Act, hedge funds are not totally different and detached from 'traditional' funds: the case of mutual funds, pension funds and insurance companies will be illustrated. Chapter 6 will take this discussion further and show how the Securities and Exchange Commission has gradually relaxed the interpretation of the law and increasingly granted mutual funds the ability to sell short.

To begin with, many mutual funds, pension funds and insurance companies have started acquiring or launching hedge funds. Interviewed regulators and practitioners referred to Gartmore as example of this trend (Ingram, interview 2001; Karki, interview 2002; Raikes and Bennett, interviews 2002). Gartmore Investment Limited, a traditional money manager and investment company previously owned by the Nat West group and in 2000 acquired by a US insurance company (Nationwide Mutual Insurance Company), has launched a range of seven hedge funds since 1999 and raised over $2 billion in assets (Gartmore 2002: 2). Another large mutual fund, Schroders Salomon Smith Barney,[32] in March 2002 announced that investment in alternative investment strategies would be lifted from 4 to 10 per cent or more of its assets under management (*The Economist* 2002). Merrill Lynch Investment Management, the mutual fund owned by Merrill Lynch, launched a similar strategy in 2001

[32] Schroders, a world leader in asset management, sold its investment banking business to Salomon Smith Barney in 2000.

(Gallo 2001c). These examples also show that by owning mutual funds banks have a further channel to get a stake in the hedge fund industry.

In addition, mutual funds have started employing internally many of the strategies and tactics of hedge funds (Gallo 2000a). According to *SmartMoney* magazine, 'there are some mutual funds out there that mimic hedge funds by going both long and short' (Smith, D. 2001). According to Hedge World, since 1998 the number of mutual funds 'going hedge funds' has increased substantially. As in the case of banks, the reasons can be found in the desire to keep hold of their wealthier customers, who would otherwise move elsewhere attracted by hedge fund returns, and retain their brightest managers, who might be tempted by the high rewards of a hedge fund career (Hedge World 2000c). More generally, the trend has been helped by the wealth effect created by the long bull market and by the development of financial services and information infrastructures supporting the hedge fund industry (for instance, the growing number and importance of vendors).

The same is happening in the insurance industry. For instance, in October 2001, the insurance giant MassMutual's Oppenheimer Acquisition acquired Tremont Advisers. Tremont is a hedge fund consultant that set up one of the largest (if not *the* largest) database on hedge funds (TASS) and that, apart from providing services to the hedge fund industry, directly manages several hedge funds. Tremont Advisers was acquired to help the insurance segment of Oppenheimer to sell hedge funds through insurance products (Colter 2001). More specifically, hedge funds are sold through a product called 'private placement variable life insurance'. This product combines a death benefit with a saving account that can be invested in different ways, including hedge funds. The main attraction of this instrument is that investment gains are tax-free and there is no income tax on dividends earned nor on the moving of assets from one fund to the other if the policy is held until death. In general, it is the very affluent that take on private placement variable life insurance. According to the *Wall Street Journal*, 'potential clients would need at least $25 million in liquid assets'

(Colter 2001). Clients in general take on the minimum amount of death benefit in order to qualify for tax exemption and then invest as much as they are allowed into hedge funds.

Similar trends are found in the pension fund industry. According to Temple, 'there has been a considerable shift among pension funds in the US, but also in the UK and Europe, to increase allocations to hedge funds. Institutions like CalPERS have made quite a thing of investing in hedge funds' (Temple, interview 2002). CalPERS is the 'California Public Employees' Retirement System', the US's largest public pension fund. It provides retirement and health benefits to more than 1.2 million state and local public employees and their families, with assets totalling more than $151 billion.[33] In October 2000 CalPERS Board agreed to establish a $1 billion hedge fund programme, which was later increased to $5 billion (Barra RogersCasey 2001: 6). Its total allocation to alternative investment strategies is about $20 billion. CalPERS's move into the hedge fund industry was seen as a catalyst for other mutual and pension fund initiatives (Freemand & Co. LLC 2001: 16). This institutional interest is set to continue if it is true, as Chapter 2 reported, that at least half of the total expected growth in capital under management in the hedge fund industry ($1.7 trillion by 2005) in the next five years will come from institutional investors (e.g. mutual funds, pension funds, etc.) (Barra RogersCasey 2001: 5).

3.4.3 Derivatives

Besides the analogy with other investment instruments such as mutual funds, pension funds and banks, hedge funds have a very close relative in financial markets: derivatives. Hedge funds make substantial use of derivatives. The case of LTCM is emblematic, as derivatives transactions were the bulk of its business. Derivatives such as put options and single-stock futures, however, are not only instruments used by hedge funds. They are also their economic equivalent.

Derivatives are so called because they *derive* their value from the value of some other asset, which can be anything from commodities, currency, stocks, bonds and so on. *Put options* are contracts that give the buyer the right to sell a fixed amount of shares or other assets at a fixed price within a given period. So, for instance, if a trader anticipates a drop in the price of a stock, they can buy put options in that stock and, if at the established deadline the stock has gone down as expected, they can buy it at the new lower price and sell it at the price set in the put option contract. In so doing, they will gain the difference between the two prices minus the option fees. It is clear that it is like hedging a long position with a short one – as in Jones's model. In other words, *put options are the equivalent of short selling*. Moreover, they are cheaper and easier than selling short: with put options the trader does not have to commit the full amount of the stock, but only the amount necessary to buy the option, that is, the put option fees. *Single-stock futures* are instead contracts by which one part promises future delivery of an asset to the buyer at a prearranged price. Contrary to options that require the payment of a fee, single-stock futures are virtually free and only require a deposit to cover potential losses (Jenkins 2000). Therefore, single-stock futures are even cheaper than put options.

The analogy hedge funds/derivatives is to be found in the history of financial theories. The derivatives revolution of the 1970s gave market players the possibility to obtain with derivatives the same results that hedge funds obtain with the combination of short selling and leverage. Black and Scholes – who together with Merton are considered the fathers of the derivatives revolution – developed an instrument close to Jones's idea of managing risk: like Jones, they aimed at converting or eliminating market risk by *hedging* a position with a contrarian one. As De Goede writes, 'what Black, Scholes and Merton argued was that, with the help of options, financial practitioners could create *risk-free* positions. As long as one purchased a set of options comprising the opposite positions to one's bets, large financial

[33] See CalPERS web site at www.calpers.ca.gov

losses would be impossible' (De Goede 2001:157, my italics). This is also the foundation of Jones's formula.

As a matter of fact, there were options and futures well before the derivatives revolution (Bernstein 1996: 304-310; De Goede 2001). What Black, Scholes and Merton made possible was to put a price on them so as to trade and have a market for them: next to the markets for commodities, stocks, etc., a market for the instruments that derived from them ('derivatives') was created. In April 1973, just before the publication of the Black-Scholes formula of option pricing, the Chicago Board Options Exchange (CBOE) was inaugurated. For the first time, the CBOE provided traders with standardised contracts and with market makers willing to take the other side of the contract (Bernstein 1996: 315). In the case of futures, the first futures contract was developed by Friedman in Chicago and predates the 1973 Black-Scholes formula (Karki, interview 2002).

To conclude, despite hedge funds and derivatives being two different instruments, they nevertheless share Jones's idea that it is possible to neutralise market risk and simultaneously increase returns. Market practitioners make the link between Jones's model and derivatives too. According to a London-based fund of funds manager, 'the common idea behind hedge funds and derivatives is that many market or systematic risks can be converted or eliminated. Before the Chicago Board Options Exchange (CBOE) opened in April 1973, people could only go long. Derivatives provided the possibility of going short as well as long (Karki, interview 2002). In other words, they provided a sort of standardisation for hedge fund strategies.

3.5 Conclusion

This chapter has analysed how a certain way of representing hedge funds limited the regulatory choices open to decision-makers in Washington and Basel. Section 3.2 looked at

the representation of hedge funds as efficiency-enhancers and showed how this argument influenced regulatory decisions: if hedge funds are performing a useful task – so was the argument – why should they be regulated? Section 3.2.1 challenged this representation and also showed that financial economics has been unable to find criteria of evaluation other than the efficiency one. Section 3.3 looked at the representation of hedge funds as predominantly offshore entities and drew attention to the biases and flaws in this argument. In particular, it was pointed out that hedge funds are prevalently managed onshore and that this is apparent once the distinction between domicile and main place of business and between number of funds and number of managers is applied. Section 3.4 looked at the discourse of difference – hedge funds as different and alternative to the rest of the investment community – and questioned its main tenets. Section 3.4.1 and 3.4.2 showed that banks, mutual funds, pension funds and insurance companies are increasingly able to act as hedge funds and hold large interests in the hedge fund industry. Section 3.4.3 described how instruments such as put options and single-stock futures can be seen as the economic equivalent of hedge funds. Altogether, these sections showed that the discourse of difference is untenable. This conclusion is crucial to analyse the regulatory debate in Basel and Washington, where the discourse of difference had a large resonance. For instance, it was at the basis of the idea of relying upon hedge funds' counterparties to indirectly regulate hedge funds (see Chapter 5).

Chapter 3 concludes the critical analysis of the first explanatory model. It has challenged the argument that tighter regulation of hedge funds is unnecessary given the empirical evidence and has shown the biases in the theorisation of hedge funds. This representation of hedge funds will be further analysed in Chapter 5, which describes how the hedge fund discourse combined with a particular regulatory philosophy to influence and direct regulatory choices towards a neo-liberal model. Before doing that, Chapter 4 introduces the second explanatory model and enters into the core of the political economy approach. Issues of power are

explicitly introduced by looking at the relational power of the actors in the debate and at the institutional setting in which the debate took place.

CHAPTER 4

THE SECOND EXPLANATORY MODEL:

The Power of Actors and the Institutional Setting

4.1 Introduction

The first explanatory model explains the outcome of the hedge fund debate only in terms of technical necessity: the empirical evidence did not give any 'scientific' reason to pursue more interventionist regulation of hedge funds. Chapter 3 challenged this way of reasoning. It showed that it was a certain theorisation of hedge funds rather than the empirical evidence per se that conveyed the idea that hedge funds are a minor and, in fact, a positive aspect of the market. In other words, it showed that there was technically no necessity for the choices made in Basel and Washington.

This chapter reinforces the argument of the political nature of the decisions taken in Basel and Washington by considering that regulatory discussions occurred in particular places and were carried out by particular actors.[34] The outcome of this debate is a consequence of the distribution of power among actors and of the institutional features of the governance arrangements set up to deal with hedge funds. This is the essence of the *second explanatory model* as developed in this chapter.

After a historical overview of the debate (section 4.2), the chapter is split into three main parts. The first (section 4.3) looks at the actors gathered at the Financial Stability Forum. Section 4.3.1 begins with a realist notion of power and analyses the FSF as an inter-state debate where states maximise their national goals and where the interests of the dominant

[34] For an analysis of the political nature of technical systems such as the governance of global finance see also Porter (2003).

states prevail. Section 4.3.2 expands this perspective. It points out that by articulating the debate only in terms of state interests important perspectives on power are overlooked. Private actors were directly involved in the negotiations, even if they did not formally appear among the members of the FSF working group, and their role needs to be spelt out.

The second part (section 4.4) challenges the realist perspective in another respect. It shows that the state interests championed in Basel cannot be understood in terms of cohesive and coherent goals reflecting a nation's preferences. They are the results of the prevalence of one social group over others at the domestic level. Section 4.4 thus moves to the national level in the US, the country from which most hedge funds are managed, and analyses the process of domestic aggregation of the interests championed in Basel. Together, section 4.3 and 4.4 show that the coalition of interests that prevailed in Basel is one that revolves around the US 'regulatory complex' – made up of the FED, the Treasury, the SEC and the CFTC – and the transnational financial community.

The third part (section 4.5) argues that this coalition has been facilitated by the institutional setting in which the debate took place. It takes the view that rule-making procedures at the Financial Stability Forum were a way to confine the scope of decision-making to safe issues (Bachrach and Baratz cited in Lukes 1974: 237) and by so doing promote the interests of the strong (Higgott 2003; Pauly 1999). In this way, section 4.5 takes a pessimistic view of the role of the Financial Stability Forum. The FSF is said to be no more than the sum of domestic contributions – with some contributions weighing more than others – and to promote no supra-national goal.

Before moving to the core of the chapter, a caveat is important. As explained in the introduction, in this debate the name 'hedge fund' recurs together with 'highly leveraged institutions' (HLIs). The Financial Stability Forum (FSF) changed the name of hedge funds to highly leveraged institutions to account for the fact that other entities, such as banks and

securities firms, can engage in the activities that have traditionally been attributed to hedge funds. The FSF report writes that the main concern of regulators is with all those entities that are 'large, unregulated and opaque institutions employing a high degree of leverage' (FSF 2000: 1), no matter what their name and legal regime is. The change of name, however, was not complete, and both names are still used interchangeably – the US President's Working Group, for instance, sticks to the name hedge funds. The change is unconvincing for other reasons too, as the next chapter will explain. However, to literally follow the 'terms' of the debate, this chapter will use 'highly leveraged institutions' each time it is used by the regulatory documents under analysis. For the rest, the name hedge funds will be preferred.

4.2 Background and phases of the hedge fund regulatory debate

Two events triggered the regulatory debate on hedge funds: (1) the Asian financial crisis and the emerging market turmoil of 1997 and 1998, respectively, and (2) the collapse of LTCM in August 1998. The first set of events brought forward issues of market dynamics and integrity, in particular the likelihood of hedge funds precipitating equity and currency crises in small open economies and emerging markets. The second event brought forward issues of systemic stability, e.g. the risk of a hedge fund like LTCM collapsing and bringing down with it a good part of the financial system. The year 1998 thus marks the beginning of the *regulatory debate* on hedge funds – intended as *a formal and public process of evaluation (both at the domestic and international level) that should lead to policy solutions.*

It has to be said that the regulatory interest in hedge funds started slightly earlier, at least at the beginning of the 1990s. Concerns about hedge funds were manifested in 1992, when the pound sterling and the Italian lira were forced out of the Exchange Rate Mechanism (ERM): Soros's bet against the sterling pound was widely considered to be the cause of the devaluation. The bond market turbulence of 1994 in the US was equally attributed to the

activities of hedge funds (Adams, interview 2003).[35] Concerns were voiced in all emerging market crises of the 1990s and especially during the Asian financial crisis in 1997. In the aftermath of that crisis, emerging markets called the US to do something about those macro hedge funds that, in their opinion, had a big part in the chain of devaluations in Asia, Latin America, Australia and South Africa. They addressed their concerns directly to the US. They implicitly said: 'Hedge funds operate mainly from your jurisdiction, so you are the one who has to do something' (Andresen, interview 2003).[36]

The US, however, did not take those concerns seriously. It was not until LTCM uncovered dangerous links between the US banking community and a largely leveraged hedge fund that a regulatory debate started being considered (Adams, interview 2003; Battelino, interview 2003).[37] At that point in fact emerging markets could say: 'If a single hedge fund can give serious troubles to the biggest financial market in the world, one can figure out what several such funds can do in emerging markets' (Adams, interview 2003).

It was at that time that G-7 countries decided to hold a discussion on regulatory solutions for the issues triggered by hedge funds. It was not, however, a convergence of intents and views between what was at stake for the US and what was at stake for emerging markets. Two independent and distinct concerns conflated in the regulatory debate in Basel: on the one hand, US concerns for systemic stability and, on the other hand, emerging markets' concerns for market dynamics and integrity. It proved to be the search for an impossible (or disingenuous) consensus, as the next section will show. The remainder of this section briefly outlines the historical phases of this debate: first, the work done by the IMF; second, the

[35] Charles Adams was the IMF representative at the FSF Working Group on HLIs and the Chairman of the Study Group on Market Dynamics (FSF Task Force). Mr Adams is now at the IMF Regional Office for Asia and the Pacific (OAP), Tokyo.
[36] Svein Andresen is Secretary General of the Financial Stability Forum Working Group on Highly Leveraged Institutions.
[37] Ric Battelino is Assistant Governor (Financial Markets) of the Reserve Bank of Australia. He was the representative for Australia at the FSF Working Group on HLIs.

initiatives taken by Washington regulators; and, third, the organisation and main lines of the debate in Basel.

The IMF Occasional Paper *Hedge Funds and Financial Market Dynamics*, prepared by a team of IMF economists led by Barry Eichengreen (May 1998), was the first publication with a regulatory intent that appeared after the Asian crisis. LTCM had not yet collapsed, and the IMF paper was only concerned with the role of hedge funds in precipitating currency and equity crises in emerging markets and small open economies in general. As Chapter 2 already pointed out, the paper took the view that hedge funds could not be held responsible for what happened in Asia. First, the paper said that the evidence collected did not support the thesis that hedge funds precipitated the Thai baht or Malaysian ringgit devaluation. The paper writes that in many cases hedge funds were holding and not shorting the currencies of the affected countries. Second, hedge funds were only one (small) group of actors among many others. In particular, it was pointed out that commercial and investment banks through their proprietary trading desks could trade exactly as hedge funds did and, what is more, with more capital under management. Finally, local players were attributed a decisive role in starting a run on the currency. In general, the crisis was seen as a result of weak macroeconomic fundamentals in the affected countries (see Section 2.10). The conclusion of the IMF Occasional Paper 166 was that an excessive focus on hedge funds was unwarranted.

According to the IMF's representative at the FSF Working Group on HLIs,[38] 'the paper was not well received by many countries in Asia, as they saw it downplaying the role of hedge funds. But it was well received in the US, both by the financial and the regulatory and policy community' (Adams, interview 2003). The IMF paper indeed left very few avenues open to question hedge funds' role in Asia in 1997. According to (Anonymous 2), the IMF

[38] Prior to represent the IMF at the FSF Working Group, Charles Adams was involved in the IMF study (IMF 1998).

argument was disingenuous: 'it was a strategy by the IMF and the US to confuse the issue and muddy the water around the debate. Confidentially, IMF people agreed that the study was disgraceful' (Anonymous 2, interview 2003). (Anonymous 2) points out that the IMF was totally indebted to hedge funds for the collection of information and data on the events of 1997 and that the person directly in charge of writing the report for the IMF went to work for a hedge fund later on. In addition, by releasing hedge funds and Western financial players from a crucial responsibility in triggering the crisis, the IMF paper contributed to rehearse the contrast between Asian countries on the one hand and the Western financial community on the other. (For an analysis of this 'politics of resentment' see Higgott 1998.)

The debate in the US was instead sparked by domestic worries for the soundness of the US financial system after one single hedge fund, LTCM, was about to provoke a collapse of dramatic proportions. In October 1998, soon after the FED-organised bailout of LTCM, the US Congress set off an inquiry on the necessity of the bailout, its consequences for the American economy and its costs for taxpayers (Committee on Banking and Financial Services 1998). Various hearings on hedge fund operations were held. At the same time, the four major US regulators – the US Treasury, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (SEC) and the Commodity and Futures Trading Commission (CFTC) – gathering in what is called the 'President's Working Group on Financial Markets' (PWG) – started working on the report *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management,* which was issued in April 1999. The PWG report provided a series of recommendations targeted at regulators and market participants, which enormously influenced the development of the debate in Basel. Many of the proposals put forward by the Financial Stability Forum are literally identical to the PWG ones.[39] Finally, in response to a recommendation contained in the PWG report, in September 1999 Congressman Richard Baker introduced to the House Banking Committee the *Hedge*

[39] In some cases, even the wording of the recommendations is identical. See for instance PWG 1999: 31 and FSF 2000: 24.

Fund Disclosure Act (Hedge Fund Disclosure Act 1999) and in November 1999 Congressman Edward J. Markey introduced to the Committee on Energy and Commerce the *Derivatives Market Activity Act* (Derivatives Market Activity Act 1999). Both legislative initiatives aimed at promoting public disclosure of hedge funds.

All these US initiatives neglected the impact of hedge funds on market dynamics and integrity in emerging markets – e.g. the concerns triggered by the Asian crisis. There is only a passing note on hedge funds' role in the crisis, which the report rejects by referring to the lack of empirical evidence supporting it (PWG 1999: A7). The PWG report only addressed the risks posed by highly leveraged institutions such as LTCM and their impact on the systemic stability of advanced markets. It is likely that, without LTCM, no domestic debate on hedge funds would have taken place in the US. The US authorities then brought this perception of the problem to the international debate in Basel.

In April 1999 the Financial Stability Forum[40] was convened to promote international financial stability and reduce systemic risk. At its inaugural meeting on April 14, the FSF was entrusted with the task of studying and formulating policy options on three issues: capital flows, offshore centres and highly leveraged institutions (HLIs). As Andrew Crockett, at the time Chairman of the FSF,[41] stated, first there was the decision to set up a forum for discussing issues of systemic stability – from which came the name 'Financial Stability Forum' – then 'we went to all members of G-7 countries and asked them which were their main concerns. The ones that came out most frequently were offshore centres, capital flows and highly leveraged institutions' (Crockett, interview 2003). An *ad hoc* working group was set up to deal with each of these issues. This thesis only examines the

[40] The FSF secretariat is housed at the Bank for International Settlements in Basel. Until August 2003, the FSF was chaired by Andrew Crockett, General Manager of the BIS.
[41] Mr Crockett served as Chairman of the FSF until March 2003. The new Chairman is Roger W. Ferguson Jr, Vice Chairman of the Board of Governors of the Federal Reserve System.

Working Group on HLIs and the recommendations the Group came up with, which were gathered in a report issued in May 2000 (FSF 2000).

Before analysing the actors and the institutional setting of the debate, it is worth spending a few words on its location and timing. This research project refers to the regulatory debate on hedge funds that took place between 1998 and 2002, internationally in Basel and domestically in the US. The focus on the US stems from the fact that, for the time being, this is the only country that has held a domestic regulatory debate on hedge funds (according to the definition of regulatory debate given in Section 4.2). The UK has partly done so, but for different purposes, with a different public resonance and, in any case, with a different impact on the discussions in Basel (Raikes and Bennett, interviews 2002; FSA 2002). Other countries have started voicing their concerns too. In February 2002, the German Finance Minister called for an international effort to regulate hedge funds (Eichel 2002). Japan showed concerns after its stock market became the target of short sellers in March 2002 (International Securities Finance 2002: 10). Ireland is becoming one of the favourite locations for the hedge fund industry and has recently changed parts of its regulatory regime to cater for hedge funds (Barr 2002b). The number of non-US hedge funds is growing very rapidly too, so that the distribution of hedge funds is no longer that of 1998 (Chapter 2: 88-92). Further research is warranted on the significance of these moves, which are set to continue. Overall, however, these moves do not challenge the argument that the US debate was the crucial one. This is for three reasons: first, the US was the country from which hedge funds were mostly operated between 1998 and 2002.[42] Second, the domestic debate in the US had an enormous influence on the development of the international one. Third, most countries intended the regulatory debate in Basel as a way to pressure the US to do something. The common view was that, if the US did not implement anything domestically, the work of the Financial Stability Forum would be vain.

As for the timing of the debate, the thesis considers the period between 1998 and 2002. In the US, the issue of hedge funds was the hot topic in 1998-2000, soon after the LTCM bailout. At the international level, the FSF started working on hedge funds in 1999 and issued its main report one year later, in 2000. Two updating notes were released in 2001 and 2002 to assess progresses in the implementation of the FSF recommendations. At the end of 2002, FSF officials considered the debate closed and did not envisage any further review 'unless something else happens and the appetite for dealing with these issues is restored' (Andresen, interview 2003). Officials in Basel say that hedge funds are no longer a media issue and that, without this spotlight pressure, they will soon be forgotten (Adams, interview 2003; Andresen, interview 2003). In May 2003 the US Congress re-opened a debate on hedge funds following the SEC's intention to investigate issues of fraud linked to the management of hedge funds (Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 2003; SEC 2003). It is difficult to assess the relevance of these new discussions, which have just started, and whether they will lead to re-open the international agenda too. Whatever the outcome will be, the thesis has provided a framework to assess future regulatory efforts. This, however, is left to further research on the subject. The thesis stops at the end of 2002.

4.3 Composition of the FSF Working Group on HLIs: which coalition of interests?

This section deals with the actors and coalitions of interests present at the FSF regulatory table. It begins by understanding the Financial Stability Forum as an inter-state debate, where states try to maximise their national goals and where the outcome of the negotiations depends on the relational power of actors. Section 4.3.1 shows how the US dominated the agenda, in the sense that it was able to impose its line and to veto all unwanted propositions. The second explanatory model developed in this chapter conceives of US power as relational power. Chapter 1 pointed out the problems with this notion of power, in the sense

[42] See Chapter 3 for a discussion of the argument that hedge funds are mainly located offshore.

that it is debatable whether the US exercised relational power and not instead structural power deriving from its weigh in financial markets. Chapter 1 argued that this consideration partly undermines the realist explanation.

A greater challenge to the realist explanation, however, comes from the difficulty of justifying the US interest in keeping hedge funds unregulated only by reference to the concept of 'national interest'. It is necessary to move away from a statist understanding of the Financial Stability Forum and towards a more complex picture of the coalition of forces, where the 'national interest' is problematised and the role of private and semi-private actors is introduced. Section 4.3.2 argues that the crucial coalition of interests is the one that develops around regulators and their regulated communities. The case of the Counterparty Risk Management Policy Group (CRMPG) is specifically considered. This perspective not only shows that power has shifts in favour of the regulated, but that regulators are becoming increasingly dependent on the very actors that they need to supervise (Underhill 1997: 25). One of the consequences of this shift is that private actors (banks, hedge funds, etc.) will hardly implement actions against their interests. From this perspective, hedge funds remained untouched because the financial community considered them too profitable a business to be spoilt by a change in their regulatory regime.

4.3.1 The FSF Working Group on HLIs as an interstate debate

The FSF Working Group on HLIs gathers representatives of G-7 countries, the Netherlands, Australia and Hong Kong. It also includes a representative from the IMF. Altogether, the Group counts 12 members. (See Appendix 2 for a full list of FSF members.) Australia and Hong Kong were among the countries where hedge funds were active in 1998 and that voiced their concerns more loudly. As Andrew Crockett puts it, the inclusion of Australia and Hong Kong was done as a way 'to reach out to non-G7 countries and by so doing gain credibility' (Crockett, interview 2003). The credibility Mr Crockett refers to is that of a

forum that moves away from the perception of being only a G-7 committee and becomes a venue where all countries' interests are accounted for.

In terms of numerical representation, the rule at the Financial Stability Forum is three representatives for each G-7 country (one from the Central Bank, one from the Ministry of Finance and one from a regulatory agency) and only one for non G-7 countries. However, the Tietmeir Report (Tietmeyer 1999), which is the precursor of the FSF work on HLIs, wanted a smaller group with only one representative for each country. So, in the end, G-7 countries too were assigned one representative each. An exception was made in the case of the US, which was allowed to keep two representatives (Andresen, interview 2003).

The search for credibility was also reflected in the choice of individual members. As the FSF Secretary General says, 'the Working Group was as capable a group as possible: all individuals involved had a closeness to the issues debated one way or another' (Andresen, interview 2003). Peter Fisher from the Federal Reserve Bank of New York, for instance, was the leader of the President Working Group (PWG) and Chairman of the Multidisciplinary Working Group on Enhanced Disclosure (MWGED).[43] Jan Brockmeijer, Deputy Director of the Netherlands Bank, was (and still is) Chairman of the Basel Committee's Transparency Group.[44] Norman Chan from the Hong Kong Monetary Authority was in charge of monetary intervention when the Hong Kong dollar suffered the attack by short sellers in August 1998. Howard Davies was chosen as chairman 'as he is a powerful personality, who would not have allowed the debate to have a weak report' (Crockett, interview 2003). Therefore, 'it was a group of people capable of delivering the highest quality of report that could be achieved in this area' (Andresen, interview 2003).

[43] See Glossary for the composition of the MWGED.
[44] A Subgroup within the Basel Committee on Banking Supervision.

Credibility was essential to gain consensus, which was the ultimate objective of regulators in Basel. The feeling at the beginning of the debate was that hedge funds had started being addressed, but too different views and aims remained present. The aim of the Group was to harmonise these views (Andresen, interview 2003). There were, however, serious disparities that could have undermined both the credibility of the Group and the consensus it could achieve.

To begin with, the Working Group on HLIs was assigned to the UK as a consequence of an old logic of partition in international affairs. As Andrew Crockett says, 'the balance between countries had to be maintained in the appointment of the chairmen of the three FSF working groups: one had to be European, one North American and one from the UK' (Crockett, interview 2003). Howard Davies, Chairman of the Financial Services Authority (FSA), was appointed for the Working Group on HLIs. As a result, the Group was somehow 'hosted' by the FSA: three out of four of the Secretariat members were from the FSA. This was not going to be without consequences, given the fact that, as the next sections will show, London supported all US claims. Second, the US was given two representatives instead of one, thus making an exception to the above-mentioned decision to limit participation to only one member for each country. In a 12-member committee, this could make a difference at the regulatory table. Moreover, the US was the country with the greatest expertise (and experience) of hedge funds. (Anonymous 1) of the IMF acknowledged that Peter Fisher (Federal Reserve of New York) and Edwin Truman (Treasury) would have been hard to contradict (Anonymous 1, interview 2003). Third, countries like Malaysia self-excluded themselves from the debate, because they thought it was not credible, it was too US-dominated and it was going to be a 'brain wash'. Malaysia had its own view on the issue and did not expect much out of the process at the FSF (ibid).

The quality of the consensus this group could achieve partly follows from what said in terms of credibility. Officials in Basel stress the consensual nature of deliberations at the Financial

Stability Forum. As the FSF Secretary General says, 'the Working Group on HLIs operated by consensus' (Andresen, interview 2003). But which kind of consensus could be achieved in Basel? Section one showed how countries went to the regulatory table with very diverse claims and expectations. Emerging markets were preoccupied with what happened in Asia, while the US was preoccupied with the recurrence of another LTCM. Second, small economies such as Hong Kong, Malaysia and Singapore, as well as G-7 countries such as France and Germany, wanted hedge funds to be 'properly' regulated. The US and the UK instead thought that regulation of hedge funds was undesirable both in the case of currency speculators and in the case of highly leveraged funds. A member of the FSF Working Group on HLIs stated in the clearest possible terms the essence of the realist perspective: 'US institutions dominate world financial markets and the US authorities think that nothing should be put in place to hinder their operations' (Anonymous 2, interview 2003).

The consensual nature of decision-making will be analysed in detail when talking of the FSF rule-making procedures and institutional setting. This section only looks at the interests that prevailed in the formulation of a consensus on the two key issue areas of market dynamics/integrity and systemic stability. The first set of issues was passed on to a specific study group, the *Market Dynamics Study Group*.[45] This group (chaired by the IMF representative) visited 6 countries most affected by hedge fund activities during the crises of 1997-1998 and issued a report on hedge funds' impact on their markets. This report was seen as 'a very high-quality part of the FSF work on HLIs' (Sabatini, interview 2003). Its conclusions, however, were clearly biased in favour of the US and its preference for an unregulated hedge fund industry. In the words of (Anonymous 3), the conclusion of the Study Group was as follows:

> The *consensus* was that hedge funds (HLIs) caused some problems, but countries were to blame too: it was difficult to distinguish hedge funds from local players, it was not possible to demonstrate that there were collusive behaviours and there was no evidence that HLIs' building of positions were the

[45] Its report is included in FSF 2000: 108.

> identifiable source of problems. This remained a very divided issue – and one of the lengthiest debates in the Working Group. It was more divided than the one dealing with the consequences of LTCM, [...] but in the end it was a *consensus* report. The case for regulating hedge funds was weak and all countries came to appreciate the imprecision of *any* regulatory framework in addressing the problem of hedge funds (Anonymous 3, interview 2003, my italics).

The second set of concerns – LTCM-type of concerns – was less disputed, as Svein Andresen said. The option was either to regulate hedge funds and in general all highly leveraged institutions or to rely upon market forces in bringing about regulatory solutions. The latter option was privileged and substantiated in a call for due diligence and self-assessment of risk targeted at HLIs' counterparties (banks, securities houses, prime brokers, etc.). This option was called 'indirect regulation'. The Working Group assigned banks and other counterparties the task of indirectly regulating hedge funds either by self-restraining their business with them or by performing particular due diligence in carrying it out. No great opposition was encountered from emerging markets. The reason is that this was more a concern with developed countries than with emerging markets, and the latter did not perceive it as crucial for their economies. A division instead emerged within the very G-7 members of the FSF, and in particular between the UK and the US on the one hand and France and Germany on the other. France and Germany brought to the regulatory table their different attitude towards free markets. They were overall more concerned with the problems raised by hedge funds and advocated a more mandatory approach to their regulation.

All FSF officials interviewed in Basel point out the difference between 'the regulatory approach of France and Germany on the one hand and the less mandatory approach of the US and UK [and the Netherlands] on the other hand' (Crockett, interview 2003; see also Freeland, interview 2003; Brockmeijer, interview 2003; and Andresen, interview 2003). A less mandatory approach means that emphasis was placed more on transparency and disclosure than on regulation. This different attitude emerged, for instance, when the French

representative Jean-Pierre Patat proposed to collect aggregate data on positions in key markets such as foreign exchange markets (Anonymous 11, interview 2003; Anonymous 10, interview 2003; Anonymous 8, interview 2003; Anonymous 1, interview 2003). The US authorities strongly ruled out this proposal as unrealistic and unfeasible. Another case was when the German authorities proposed to set up an international credit register to track counterparties' exposures to hedge funds, which once again was forcefully opposed by the US representatives (ibid).

To conclude about the nature of the consensus reached by the FSF Working Group, it is true that participating countries *formally* agreed on the report that emerged from the discussion. However, as some countries' demands were completely overlooked, a consensus could have been achieved only 'by writing a report that says very little. It contains great analysis, but the final proposals are "hot air"'. This was the case with all the reports written in relation to the FSF debate: IOSCO, MWGED, etc. These reports in fact have not led to radical changes' (Anonymous 10, interview 2003). In other words, it was not co-operation among countries that prevailed at the regulatory table, but US relational power. The words of a BIS official are particularly enlightening. Asked about the process to reach a consensus on hedge funds, Anonymous 5 answered:

> Hong Kong and Australia might be unhappy, but if the US does not want to do it [to regulate hedge funds], there is nothing that can be done (Anonymous 5, interview 2003).

4.3.2 The FSF Working Group on HLIs as a condominium of public and private interests

The discussion in the previous section raises two main questions. First, which was the US interest in keeping hedge funds unregulated? Second, is the image of the FSF as an inter-state debate totally justified? Both questions lead to a consideration of the private actors involved in the debates and of the nature of their involvement.

Many reasons would suggest that the regulation of hedge funds was in the US 'national interest'. Regulation could reduce the likelihood of insolvencies caused by excessive speculative strategies; it would consequently reduce the money spent on bailouts; it could address issues of manipulation and fraud and tackle the distributive impact of hedge fund strategies. It was not, in other words, the 'US' interest that was championed in Basel. Chapter 3 explained how hedge funds have become a very profitable business for banks. Any regulation of hedge funds would have affected not just the hedge fund industry but also banks. The US interest, in other words, has to be more narrowly conceived as the interest of the banking community and, in particular, of its most global and sophisticated section (haute finance).

As for the second question, the membership of the FSF Working Group on HLIs does not stop at the states that formally compose it. The Working Group drew from a diverse set of pre-existing or *ad hoc* committees, groupings, organisations, and individuals that have both public and private sector features. The contribution of the following actors is acknowledged in the FSF Report: the Basel Committee's Working Group on HLIs, the Basel Committee on Banking Supervision, the US President's Working Group (PWG), the Multidisciplinary Working Group on Enhanced Disclosure (MWGED), the Committee on the Global Financial System (CGFS), the International Swaps and Derivatives Association (ISDA), the Counterparty Risk Management Policy Group (CRMPG), the International Organisation of Securities Commissions (IOSCO) Hedge Fund Task Force, a group of five large hedge fund managers, and the separate report by another large hedge fund, Tiger Fund (FSF 2000: 1-4; see Glossary for the definition and composition of these associations and groups). Their suggestions are incorporated into the final FSF report (FSF 2000: 50).

Among private actors, the role of the Counterparty Risk Management Policy Group (CRMPG) was crucial (CRMPG 1999). The CRMPG is made up of 12 Western (mainly US) commercial banks and securities firms that got together to develop sound practices for

risk management in banking and securities firms. It was the President's Working Group (PWG) that first referred to their work as example of a private sector initiative that could foster improved standards in the industry (PWG 1999: 37). The aim of the CRMPG is to promote a policy transfer of good practices from leading firms to the other firms in the industry. The FSF relied upon the CRMPG to develop recommendations on stronger risk management by hedge funds' counterparties (which are the FSF core recommendations, FSF 2000: 22-23).

The PWG report also called for hedge funds to undertake a similar initiative for their own industry. It writes: 'A group of hedge funds should draft and publish a set of sound practices for their risk management and internal controls' (PWG 1999: 37). As a result, in April 2000 five large macro hedge funds (mainly operated from the US) issued the *Sound Practice for Hedge Fund Manager Report* (2000), which the FSF relied upon for its recommendation on enhancing risk management in the hedge fund industry.

The ties between hedge funds and banks are evident from the text of the two reports. Hedge fund and bank managers came up with very similar suggestions for risk management practices in their respective industries. In addition, the CRMPG includes, among its members, representatives of the hedge fund industry.

The US imprint is apparent in both reports: (1) both groupings are organised and operated from the US; FSF officials usually meet them in New York; their membership reveals a majority of US firms. It would be limiting, however, to see these private actors as the sole expression of the US financial community. The community that influenced the process in Basel is much more transnational in character. Even though many of its members are from the US, its objectives, geographical focus, managers, investor base and range of activities are clearly transnational. For instance, observers point out that most of the investments into

US hedge funds (or banks' hedge fund activities) have traditionally come from European investors (Karki, interview 2002).

The point to be made here is that the CRMPG and the hedge fund group evidence a delegation of authority from the public to the private sector. It was the President's Working Group to call upon private actors to implement industry guidelines, which were then taken on by both domestic and international regulatory bodies. This means that the very players that were to be the subject of regulation drafted most of the recommendations on risk management. This shows how much private actors are called on to self-assess their own activities and risk. Regulators praise these private initiatives as a sign that financial players are capable of responsible behaviour. As (Anonymous 5) says, 'the CRMPG is a great achievement given the fact that it was drafted by the private sector' (Anonymous 5, interview 2003). It is true that the private sector can capitalise on a much bigger expertise and, given the complexity of today's financial markets, regulators would not be able to supervise and monitor each participant or transaction. Yet this delegation is not without consequences for the quality of regulation. In particular, it raises problems in terms of content (content that is too taxing will not be included) and implementation (implementation of self-imposed rules is difficult to assess).

It is important to notice that a private element is also present in other groupings that in principle are official-sector-led organisations. To begin with, all the groupings and committees that participated in the FSF debate on hedge funds are indebted to the private sector for the provision of data. This was the case for the *Multidisciplinary Working Group on Enhanced Disclosure* (MWGED), which was set up to enhance public disclosure in the banking and hedge fund industry and fully relied on those industries for the provision of data and the analysis of trends (MWGED 2001). It was also the case for the *Study Group on Market Dynamics*, which relied upon interviews with hedge fund and bank managers. More generally, this is a feature of most of the above-mentioned groupings and committees (see

page 13). A private element is present even in seemingly public institutions such as domestic regulatory agencies. The Financial Services Authority, which since 2001 is in charge of all sorts of financial market regulation in the UK, is funded by fees paid by the industry that it is due to supervise and regulate (FSA 2002: 23). This makes the FSA more like a service provider than a regulator and the distinction public/private sector a very difficult one to maintain.

Overall, the temptation to see the private sector as opposed to the official one should be resisted. Following Underhill, it would be more appropriate to speak of a 'closed policy community' of private and public interests (Underhill 1997: 24). This point is reinforced by the fact that most of the time public and private actors speak with a single voice and do not diverge much in their objectives. When the US representatives at the FSF in Basel opposed the French proposal to disclose aggregate positions in the foreign exchange market, US public and private actors (regulatory agencies, banks, pension funds, insurance companies, etc.) spoke together, though in different contexts, against it. This condominium is evident throughout the working of the FSF, which is composed of representatives of national regulatory agencies who in turn liase with and receive inputs from a much broader community made up of commercial and investment banks; hedge funds; self-regulatory organisations such as IOSCO and ISDA; *ad hoc* committees such as the Multidisciplinary Working Group on Enhanced Disclosure, and more established organisations such as the Basel Committee and the Bank for International Settlements.

The next section yet again analyses the role of private financial actors by moving to the regulatory debate in the US and by observing the aggregation of the US interest that was championed in Basel. This will challenge the realist perspective by showing that state interests cannot be understood in terms of cohesive goals reflecting a nation's preferences, but are the results of the prevalence of one social group over others at the domestic level.

4.4 The domestic aggregation of interests: the case of the US

In 1998, when the regulatory debate on hedge funds began, the US was the country from which most hedge funds operated. Even when their legal domicile was in offshore centres, operations were largely carried out from the US. Domestic processes in the US, therefore, were crucial if it is true that 'the Working Group was set up to pressure the US' (Anonymous 2, interview 2003), as Section 4.2 said. In explaining the outcome of the debate in the US, considerations will focus on the actors and the initiatives they undertook (subsection 4.4.1) and on the rule-making procedures characterising these initiatives (subsection 4.4.2). In this way, the one- and two-dimensional views of power will be considered in the domestic case too.

4.4.1 Main actors and initiatives on hedge funds

As previously mentioned, the first regulatory move in the US was a study carried out by the President's Working Group on Financial Markets (see Section 4.1). The PWG is comprised of the Secretary of the U.S. Treasury and the respective chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission and the Commodity Futures Trading Commission. In addition to the PWG, the debate was carried out at the House of Representatives, where two bills on hedge funds were introduced. This section analyses the role of these actors in addressing the issue of hedge funds.

The PWG report was issued in April 1999, slightly more than one year before the FSF one (May 2000). It contained a series of policy recommendations targeted at the systemic-stability concerns triggered by hedge funds, that is, at the LTCM-type of problems. The main recommendations of the report called for:

(a) increased public disclosure in the hedge fund industry and among hedge funds' counterparties and credit providers;

(b) enhanced supervisory oversight of counterparties, including more risk sensitive approaches to capital adequacy;

(c) improved counterparty risk management practices;

(d) reform of bankruptcy and insolvency procedures.

A final recommendation concerned incentives to encourage offshore centres to comply with internationally agreed-upon standards. This last recommendation was dealt with in another FSF Working Group – precisely the one on offshore centres – and thus will not be analysed in this context. Some of these recommendations required changes that could only be done legislatively by the Congress, while others could be implemented administratively.

(a) Increasing public disclosure of hedge funds and their counterparties

With this recommendation the PWG urged initiatives to improve the quality and quantity of information on hedge funds as well as on public companies' exposures to hedge funds. For the disclosure of hedge fund activities, the PWG distinguishes the situation of those hedge funds that are Commodity Pool Operators (CPOs) and Commodity Trading Advisers (CTAs) and are already required to file with the CFTC (Chapter 2: 78) and those that are not. For the first category, the PWG urges the CFTC to implement the following changes: CPOs should file with the CFTC quarterly rather than annually; and information should include 'more meaningful and comprehensive measures of market risk' (PWG 1999: 33). For the second category, the Congress 'would need to enact legislation that authorises mechanisms for disclosure' (ibid). 'Such legislation – the PWG continues – should be solely for the purpose of promoting public disclosure' (ibid). For the disclosure of public companies' exposures to hedge funds, the PWG calls upon the SEC to take steps to ensure that public companies (banks, etc.) disclose their material exposures to significantly leveraged financial institutions. The PWG suggested including these disclosures in the periodic reports (e.g. form 10-K, form 10-Q) that public companies file with the SEC.

What happened to these calls in terms of implementation? As for the call upon the CFTC, this agency issued a *concept release* asking comments on the PWG proposed changes to the

regulation of CTAs and CPOs (Walek, interview 2002; CFTC 1998; see also FSF 2000: 31). The proposed rule change (proposed rule 4.27), however, died in 2000. According to Kevin Walek of the CFTC, 'the industry was so adamantly against it that we did not implement it anymore' (Walek, interview 2002). Therefore, CTAs and CPOs are still only subjected to an annual reporting requirement, which does not gather information on value at risk or levels of leverage, as the PWG instead recommended.

As for the call upon the Congress to enact legislation on hedge fund disclosure, two bills were introduced to the House of Representatives. On 23 September 1999, Congressman Richard Baker introduced to the House Banking Committee a bill that

> Require[s] unregulated hedge funds to submit regular reports to the Board of Governors of the Federal Reserve System, to make such reports available to the public to the extent required by regulations prescribed by the Board, and for other purposes (H.R. 2924, 1999).

This Act was referred to as the 'Hedge Fund Disclosure Act'. According to (Anonymous 13), 'the general concern of the Act and the people introducing it was the unavailability of knowledge about hedge funds' value at risk (VAR). Even counterparties could not figure out the overall risk of hedge funds' (Anonymous 13, interview 2002). The act required unregulated hedge funds – defined as any hedge fund with a capital of $3 billion or more – to make a quarterly report to the Board with the following information: (1) total assets, total notional amount of their derivatives position and leverage level; (2) 'meaningful and comprehensive measures of market risk' (HR 2924, 1999); (3) any other information that regulators may require. Reports were supposed to be made available to the public with a notable exclusion: 'proprietary information concerning investment strategies and positions' had to be kept confidential (H.R. 2924, 1999: 6).

What happened to the Act? The same thing that happened to the CFTC proposed rule 4.27: it died in 2000 with the end of the 106th Congress. As a matter of fact, it should be referred to as a 'bill' rather than an 'act', as it has never become an act under US Law. In the US

legal system, all bills that have not been enacted before the end of Congress automatically die and cannot be resumed without starting the process all over again.

The end of the Congress, however, might not be the reason for the non-implementation of the H.R. 2924. According to (Anonymous 13), the bill was never intended to become law. Congressman Baker did not want to see hedge funds regulated, but to send a warning message to hedge funds and banks. Baker implicitly said to the hedge fund community: 'other people want to restrict hedge funds more than I do. There is pressure on the part of the public to do something, so it is better if you do it your way' (Anonymous 13, interview 2002). As (Anonymous 13) said, 'after 2000 we never brought up the Bill again and I do not foresee a move by Mr Baker to reintroduce it' (ibid).

Even if the bill had been enacted, however, its implementation would have been highly unlikely or ineffective. First of all, the bill targets those hedge funds with a capital of $3 billion or higher. As regulators themselves recognise (Anonymous 14, interviews 2002 and 2003), $3 billion is too high a threshold to be of any significance. Very few hedge funds have such a capital and, even if they did, it would be easy to keep their size just below the threshold so as to avoid disclosure requirements. Second, the bill adamantly excludes proprietary information from the reporting requirements: 'no [...] regulation may require an unregulated hedge fund to reveal proprietary information' (H.R. 2924, 2000: 6). Market observers also point out the limitations that this provision entails. Peter Temple, for instance, argues that proprietary information should be reported, as otherwise it is difficult for supervisors to assess the riskiness of hedge fund activities (Temple 2001: 187). Third, and most important limitation, the bill sets that hedge funds have to report quarterly to the Federal Reserve Board of Governors. This assumes that the Board has the power to receive and process this information, that is, that requesting information from hedge funds is within the Board's jurisdiction. A brief digression on the principles of market regulation in the US explains why this is not the case.

Authorities in the US can only enforce public disclosure if there is an issue of investor protection. Hedge funds, however, are unregulated precisely because they benefit from an exception in the Investment Company Act, which was designed for funds that do not trigger any investor protection concern. The inclusion in the Bill of this recommendation on public disclosure is against the exceptions of the Investment Company Act. The Board, therefore, would have had no authority over it and would have 'felt very uncomfortable to receive information it did not know what to do with: this would have increased the moral hazard assumption that the FED had knowledge of hedge fund activities and could intervene accordingly' (Frankel, interview 2003;[46] see also Andresen, interview 2003). This is why the FED strongly opposed this provision. This issue alone would have been enough to block the effectiveness of the Hedge Fund Disclosure Act.

Another bill introduced to the House of Representatives two months after the introduction of the Hedge Fund Disclosure Act (and precisely on the 18th of November 1999) addressed the regulation of hedge funds in similar terms. Named 'Derivatives Market Reform Act of 1999' (H.R. 3483, 1999), the bill was introduced to the House Committee on Energy and Commerce by Congressman Edward Markey. Rarely mentioned in the literature on hedge funds (the only reference is in a note of the FSF 2000 report), Title III of the HR 3483 lists a series of disclosure requirements hedge funds should be subjected to. The focus is once again on the reporting or disclosure requirements by 'unregistered hedge funds' (e.g. non registered with the SEC). This time, however, the threshold is 1 and not 3 billion dollar. In addition, and more wisely than the Baker Bill, the Markey Bill addresses regulators' lack of authority to enforce public disclosure by proposing an amendment to the Investment Company Act:

> Sec. 301. Public Reporting by Unregistered Hedge Funds [...] would amend Section 30 of the Investment Company Act of 1940 by adding a new subsection (k). Paragraph (k)(1) would require unregistered hedge funds to file reports with

[46] Allen Frankel is Head of Secretariat of the Committee on the Global Financial System (CGFS).

> the Commission no later than 15 days after the end of each calendar or fiscal quarter. Such reports [...] shall including the following information for each pooled investment vehicle that is part of the unregistered hedge fund: A statement of the financial condition as of the end of the quarter; B statement of income (loss) for the quarter ended; C statement of cash flows; D statement of changes in equity; E description of the models and methodologies that the pooled investment vehicle uses to calculate, assess, and evaluate market risk; F such other information as the Commission, in consultation with the other financial regulators, may require by rule or regulation (H.R. 3483, 1999).

According to Jeff Duncan of the office of Congressman Markey, this Bill went far beyond the Baker Bill in terms of comprehensiveness and forcefulness. It affected hedge funds not only by placing public disclosure requirements upon them, but also by urging the SEC to issue a final large-trader reporting rule (Duncan, interview 2002). Congress gave the SEC this authority in the Market Reform Act of 1990, in order to assure that the SEC could track the trading activities of hedge funds and other large traders for market surveillance and other purposes. As Markey writes, however, 'nearly 10 years later the SEC has failed to issue a final rule, and the draft rules it issued years ago are gathering dust. Our bill would change that' (Markey 1999).

What happened to the Markey Bill in terms of implementation? The same that happened to the Baker Bill: it was not enacted, for it died with the end of the 106th Congress (Duncan, interview 2002). As far as the SEC large trader reporting rule is concerned, the SEC does not seem to have implemented any new rule that goes into the direction proposed by the Markey Bill.

According to (Anonymous 13), this 'legislation without enactment' has had a role in sparking private sector initiatives. Yet this does not seem to be true either. Even the Multidisciplinary Working Group on Enhanced Disclosure – which cannot be seen as a radical voice, were only for the fact that it is chaired by the same person that represented the US in the FSF Working Group on HLIs and that strongly opposed regulation of hedge

funds[47] – is rather pessimistic on the achievements in terms of disclosure 'both on the part of regulated and unregulated firms' (MWGED 2001).

The last PWG recommendation on disclosure targeted the SEC and concerned the initiatives that the SEC could implement administratively without the need of legislative actions. The PWG urged the SEC to implement new rules to assure disclosure of public companies' direct material exposures to significantly leveraged institutions.[48] This was intended as a means to strengthen private market discipline upon these companies, as, in this way, difficulties originating in one firm or excessive exposures to leveraged funds would be visible to all market participants. This visibility was deemed capable of preventing a domino effect or bank-run. This information should have been included in the periodic reports that public companies file with the SEC. (The same provision was also included in H.R. 2924, 2000: 9.) Did the SEC implement these new rules? At the time of writing, no rule has been formulated and enforced.

(b) Enhancing oversight of counterparties and (c) improving risk management

Recommendations two through five of the PWG report concern hedge funds' counterparties. They are core to the PWG report and are equally central to the debate in Basel. The meaning of this shift from hedge funds to their counterparties will be thoroughly explained in Chapter 5. For now, it is sufficient to say that regulators thought the appropriate way of tackling hedge funds was through their counterparties (banks, securities firms, broker/dealers, etc.). The argument was that it is only through these institutions that hedge funds can operate and, moreover, most of these counterparties are regulated entities over which domestic supervisors have a better control. Within this logic, the second recommendation is to enhance supervisory oversight over hedge funds' counterparties: 'banking, securities, and futures regulators should monitor and encourage improvements in

[47] The MWGED was chaired by Peter Fisher and for this reason was also called the Fisher Group.

the risk management systems of regulated entities' (PWG 1999: 34). The third recommendation is to improve counterparty risk management practices in the banking and hedge fund industry: 'financial institutions should continuously review their own risk management procedures [and] as a group should also draft and publish enhanced standards for risk management' (PWG 1999: 36). Section 4.3.2 has already mentioned the initiatives of the CRMPG and of the group of 5 hedge funds. The fourth recommendation aims at promoting more risk-sensitive approaches to capital adequacy, so that firms will have to put aside more capital if they deal with hedge funds without the required due diligence. Finally, the fifth recommendation is to enhance oversight of the unregulated affiliates of broker-dealers and futures commission merchants (FCMs).[49] It is argued that the SEC, the CFTC and the Treasury should be granted more authority over these market participants and the highly leveraged institutions they deal with. In particular, the SEC and the CFTC should be authorised to require unregulated affiliates of broker-dealers and FCMs to report credit risk information by counterparty.

In terms of implementation, this is the only set of recommendations where something has been done, particularly for what concerns banking supervision. The Federal Reserve, for instance, has expanded its Trading Manual to include new sections on banks' dealing with hedge funds and the risks this poses. Officials in Washington and Basel say that banks are now more prudent in their exposures to significantly leveraged institutions and that supervisors monitor these exposures more carefully. Yet, outside manuals, it is difficult to say what has really changed, and this precisely because improvements have mainly occurred through increased due diligence by banks, which is hard to assess. As Crockett writes, 'consider [...] how little counterparties knew about the exposures of LTCM. *And how little information is still available about the risk profiles of financial institutions generally*' (Crockett 2001, my italics).

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[48] Public companies include both financial and non-financial public companies that have direct exposures to significantly leveraged financial institutions.

Increased due diligence means that banks have self-restrained their lending to hedge funds and thus reduced the leverage they provide hedge funds with. Supervisors have to monitor whether banks have effectively done so. But in the relationship between banks and supervisors, the former are becoming increasingly powerful.

Banks create the very models of risk upon which they will be supervised. Supervisors only assess whether these models make sense and whether banks stick to them. Yet supervising banks on the basis of models that they create might produce a 'smart escape' from regulation. This is particularly true given that many more resources and talents go to the private sector than to the public one: i.e. the salary structure in financial markets is such that the most skilled economists go and work for the private sector.[50] For these reasons, and more that will be examined in the next chapter, it is fair to say that a delegation of authority to the very actors that need to be supervised has been operated and that private actors are increasingly becoming rule-makers in financial markets. (For a literature on private authority see for instance Cutler et al.1999; Porter 1993; Underhill 1997) Banks and hedge funds are no exception, as the case of CRMPG shows. Improvements are even more difficult to assess in the case of securities firms and futures commission merchants. The overall impression, however, is that the SEC and the CFTC have not implemented most of the changes envisaged for securities firms (large trader reporting rule, concentration information for large counterparties, etc.).

(d) Reform of bankruptcy and insolvency procedures

Recommendation number six of the PWG report calls for a reform of the US bankruptcy and insolvency procedures. More specifically, the PWG urges the introduction of closeout netting to allow solvent counterparties to net across different contracts and replace

[49] See Glossary.

terminated ones. This would prevent the failure of one institution from causing a 'domino effect' throughout the market, as was the case with LTCM. As the PWG report writes, 'these provisions serve to reduce the likelihood that the procedure for resolving a single insolvency will trigger other insolvencies due to creditors' inability to control their market risk' (PWG 1999: 26). This call materialised in a legislative action by the Congress, with the introduction of the *Bankruptcy Reform Act* in February 1999 (H.R. 833, 1999). Title X of H.R. 833 deals precisely with the reform of financial contract netting. In addition, Title IX establishes that the jurisdiction of a main insolvency proceeding of an offshore fund should be determined by the principal place of business rather than by its legal domicile. LTCM, for instance, was a partnership organised in the Cayman Islands. Though the management of the Fund took place in Connecticut, 'it is believed that the Fund itself would have sought bankruptcy protection in the Cayman Islands courts, under Cayman law' (PWG 1999: 27). Because of this, a bankruptcy could have not been filed without enormous losses for all the parties involved and the banking system. HR 833 was supposed to allow counterparties to get the protection of the US bankruptcy code even if a fund were legally domiciled offshore.[51] This legislative initiative was passed by the House of Representatives in 1999 but was then blocked by the Senate in 2000. Contrary to the other initiatives that died with the end of the Congress, this one was re-introduced in May 2003 (H.R. 2120) and is under examination at the House of Representatives. It is difficult to predict the outcome of the new Congressional debate. Yet the important provision of Title IX, which concerns the distinction between legal domicile and principal place of business, has already disappeared from the new text introduced in May 2003.

[50] Though this might sound like a crude generalisation, it reflects a common view among market players.

[51] Title IX is shaped upon the model statute of the United Nations Commission on International Trade Law (UNCITRAL).

4.4.2 Rule-making procedures in the US regulatory process

The US regulatory debate on hedge funds proved to be a regulatory failure. First, the US Congress did not pass any of the bills introduced to regulate hedge funds and it formulated them in a way that would have made their implementation impossible had the bills become law. Second, US regulatory agencies did not implement any administrative reform to the regime of hedge funds. Finally, the only changes to the regulation of hedge funds were made dependent upon counterparties' due diligence, which for its own nature is very difficult to be assessed (see Chapter 5).

Apart from actors' unwillingness to change the regulatory regime of hedge funds, what was the role of the rule-making procedures and, in general, of the institutional setting in which the debate took place? In which way did they keep certain concerns outside the policy agenda and limited it to 'safe issues' (Lukes's two-dimensional view of power, Chapter 1: 47)?

Rule-making procedures are here defined as the system by which rules are made in a regulatory setting and more precisely the way: (1) issues are debated; (2) decisions are taken; and (3) recommendations (international level) and law/regulations (domestic level) are implemented. Three procedures are herein considered. The first is the procedure of the 'concept release', which is used by the SEC and the CFTC to collect comments from those affected by a change of rule. It concerns the way issues are debated. The second is the 'legislation without enactment' that has characterised almost all the legislative initiatives on hedge funds. It concerns the way decisions are taken. The third one (inextricably linked to the second one) is the increased used of non-accountable criteria of regulation such as due diligence and self-assessment of risk. It concerns the way decisions are implemented.

The procedure of the concept release has increasingly been used by the CFTC and the SEC in the US and by the FSA in London to bring about a change of regulation. It consists in

proposing a change of rule and asking those actors that will be affected by the change to post their comments to the regulatory agency. Regulators then adopt a decision on the basis of the comments they receive. It is clear how much power this procedure gives to the very players that need to be regulated. It is true that comments can in principle be sent by anyone and can voice different interests and concerns. It is unlikely, however, that a change of rule concerning CTAs and CPOs will be watched out by anyone else than CTAs and CPOs. It is also unlikely that the CFTC will take into account comments from industry outsiders, which are viewed as non-directly involved. In other words, this rule-making procedure reflects features of the 'closed policy community' and of the 'legitimacy deficit' Underhill talks about (Underhill 1997: 24; 38).

The 'legislation without enactment' raises another kind of concern. The traditional sites of political legitimisation (decision-making and voting through the Congress or implementation through the agencies empowered by the Congress) are bypassed. This could be explained as a particular case of what Gill called 'neo-constitutionalism'. While for Gill laws, regulations and various institutional arrangements are designed to 'lock-in government commitments to disciplinary neo-liberalism' (Gill 2001: 2),[52] in the cases illustrated in this chapter it is the non-implementation of laws and regulations that constrains governments' choices to the preferences of the financial community. The result, however, is still one of ensuring that 'the commanding heights of economic strategy are insulated from popular sovereignty and accountability' (ibid: 8).

While bypassing the traditional sites of political legitimisation, decisions in financial markets are increasingly taken and implemented through non-accountable mechanisms such as due diligence and self-regulation. Due diligence, which was the specific outcome

[52] The quote is from the version of Gill's paper 'Constitutionalizing Inequality and the Clash of Globalizations' that he presented at the 42nd Annual Convention of the International Studies Association, February 2001. The paper was published in 2002 in the International Studies Review, see References.

Congressman Baker was aiming at, means letting private actors sort things out by themselves in a non-binding way. This means relying upon a coincidence of interests between regulators and regulated and between these two categories and broader sectors of society. This coincidence, based on the assumption that by performing due diligence credit providers enhance both their own interest and the interest of the community, might not be there. First, there are incentives to take on risky activities even when it is against the firm's financial safety. Second, private actors will relax their self-imposed rules and good practices once the storm is over and competitive pressures are mounting again (Freeland, interview 2003,[53] Andresen, interview 2003, Frankel, interview 2003, Tsatsaronis, interview 2003,[54] Adams, interview 2003, Battelino, interview 2003, Crockett, interview 2003). The emphasis on due-diligence, therefore, translates into another 'blessing' to the hedge fund industry and a furthering of the legitimacy deficit.

The unwillingness of US regulators to implement any change to the legal regime of hedge funds moved from Washington to Basel, where the US authorities blocked any proposal to regulate hedge funds at the international level. Even without the US opposition, however, the very fact that the US authorities did not implement any of their domestic initiatives automatically undermined the process in Basel. The FSF report is full of references to the legislatives and administrative initiatives undertaken by Washington, but no follow-up note has been released to acknowledge and rectify that those initiatives failed or never took off.

4.5 Rule-making procedures at the FSF

Section 4.3 described how the FSF credibility, especially among emerging markets, was undermined by its incapacity to move beyond the US's will. 'It is a brain wash', the Malaysian authorities, which did not participate in the negotiations, said (Anonymous 1,

[53] Charles Freeland is Deputy Secretary General of the Basel Committee on Banking Supervision.
[54] Kostas Tsatsaronis is Head of Financial Institutions and Infrastructure at the BIS.

interview 2003). Other non-G7 countries, such as Hong Kong and Australia, did participate in the Working Group, but were upset at the way the debate was conducted and frustrated that the final recommendations did not endorse any substantial change to the regulation of hedge funds.

This section examines the role of the FSF institutional setting in affecting the outcome of the debate. More precisely, it asks whether this institutional setting is a venue where a plurality of interests can be accounted for (Germain 2002) or is just a conduit for the interests of the dominant players to prevail (Pauly 1999; Higgott 2003). The answer will be articulated by looking at the whole sequence of rule-making procedures (how issues are debated, how decisions are taken and how recommendations/laws are implemented) at the FSF.

Section 4.3 showed how each country participating in the FSF Working Group on HLIs was assigned a seat with the exception of the US, which was given two seats. It was also said that there would not have been a debate on hedge funds had FSF officials not decided to go around and ask *G-7* representatives which issues they wanted to address. This raises a series of questions as to the significance of an international debate hosted by the Bank for International Settlements and the Financial Stability Forum.

In its statutory objectives, the FSF set itself as a forum for 'national authorities responsible for *financial stability in significant international financial centres*' (FSF 1999). This means that the FSF is dealing with financial issues affecting leading financial markets. In other words, its statutory objectives do not include the direct interests of developing countries and emerging markets. Despite goodwill to open up to non G-7 countries, the Financial Stability Forum remains a G-7 organisation that 'invites' inside its structure (objectives, regulatory philosophy, decision-making procedures and so on) non-member countries like Hong Kong or Singapore. These conditions had a bearing on the outcome of the decision-making

process and, to begin with, on the kind of issues that were debated and the way they were debated.

Issues of systemic stability were the ones that most interested the FSF constituencies (G-7 countries). The concerns that small economies like Hong Kong, Malaysia and Australia manifested vis-à-vis hedge funds were of a different nature: they were concerned that hedge funds could manipulate their markets by taking large and concentrated short positions in their currencies. This was not a preoccupation that could be shared by developed countries. 'The capacity to trigger market disruption in developed countries is not there: it might be there for a single company, but not for the market as a whole' (Tsatsaronis, interview 2003). The FSF venue, therefore, was by its own nature bound to foster one set of issues – the systemic stability ones – at the expenses of another – market dynamics and integrity. This was also clear from the way the discussions on market dynamics were perceived. The whole debate was seen as a way to disprove the claims of emerging markets. The Study Group on market dynamics was assigned 'the task to delve in it to batter the claim of emerging markets that there was a real problem with hedge funds' (Anonymous 3, interview 2003).

As for the way decisions were taken, 'the FSF works by consensus' (Andresen, interview 2003). It is not an assembly where decisions are voted. Recommendations have to come up in the form of an agreement, a compromise, where contested issues are harmonised. The interview fieldwork evidenced that participants went to the regulatory table with very different claims and that many issues were highly contested. The most contested one was the debate on market integrity, in which emerging countries wanted a more forceful agreement on the regulatory treatment of hedge funds. In the end a consensus was achieved even on this issue and many authors would see it as a sign of increased legitimacy in the governance of global finance (Germain 2002). Yet a look at the *quality* of the consensus achieved on market dynamics and integrity discards this optimistic view. The recommendations that came out on this point were particularly weak and almost none of the

emerging markets' demands were met. In other words, a consensus was achieved only at the expense of the quality of the recommendations, which were reduced, as an FSF representative said, to 'hot air' (Anonymous 10, interview 2003).

The appeal of a consensual decision-making procedure rests on the simplification that derives from it: consensus means that there will be an agreement on the best set of policy options to be adopted for a particular regulatory problem and a standard procedure to be followed by all countries. Consensus, however, also conveys the impression that the problem has been taken care of and that, as a consequence, can go out of the spotlight. Asked about the aim of the Working Group on HLIs, (Anonymous 3) replied that its purpose was to 'have a political consensus on what to do and put this issue to bed' (Anonymous 3, interview 2003). Talking about securitisation, Jenny Edkins says something that can apply to many regulatory debates on finance: 'When an issue becomes [...] part of public policy, requiring government decisions and resource allocations, it becomes for me "depoliticised"' (Edkins 1999: 11). By depoliticisation she means that issues are even more firmly constrained within the prevailing framework (of meaning, of power, of rule-making procedures, etc.). From this perspective, Malaysia's definition of the FSF debate as a 'brain wash' makes perfect sense. This notion of depoliticisation can apply to many other *ad hoc* committees and forum that are put in place in the wake of a financial crisis or major event (e.g. LTCM, Enron) and that, once the media coverage lessens, disappear from regulatory tables as well as from public discussion.

Moving to the last phase of the rule-making procedure, e.g. how recommendations are implemented, another governance deficit is evidenced: an enforcing mechanism that can ensure compliance in each domestic setting is lacking. The implicit assumption of a forum like the FSF is that it is in the self-interest of each country to comply (as much as it is in the self-interest of private actors to perform due diligence). Yet this assumed harmony of interests is unlikely to work in the absence of enforcing mechanisms.

This governance deficit affects most decision-making processes in global finance. The reality of the current global financial architecture is that the FSF, as many other similar vehicles, is just 'a group where people discuss issues, but no legal weight is attached to it' (Adams, interview 2003). There is no 'global' or 'international regulator' that has enforcing powers (Scholte 2002: 199) and that can be something more than the sum of domestic contributions. As (Anonymous 1) said,

> 'My guess is that in 10-15 years we will need a global regulator, but at the moment we are nowhere near that. The reason is that the current set-up is very favourable to the US. As it is the major player, the US is not supportive of this kind of regulatory efforts at the international level but prefers to set the rules and persuades the others to follow' (Anonymous 1, interview 2003).

The lack of enforcing mechanism contributed to the failure of the hedge fund debate. While the FSF took for granted that US regulators were implementing domestic initiatives to subject hedge funds to some form of control or supervision, no mechanism was in place to check that those rules had been implemented according to schedule.

Moreover, not only do current financial arrangements include no semblance of a centralised global or international regulator, but also the simple co-ordination among domestic regulators is weak and ineffective. While the activities of financial institutions (banks, insurance companies, etc.) can be global, in the sense that they can be carried out in different jurisdictions – choosing among the legal regimes of different countries – their regulators remain local. If Goldman Sachs decides to carry out its derivatives transactions in London and its broker/dealer activities in the US, regulators in the UK and the US will only have a partial picture of its exposure and risk and therefore a partial effectiveness in their intervention. They dialogue but they do not act together (Frankel, interview 2003). There is no global 'controller' that can harmonise domestic efforts in the face of global financial activities.

For all these reasons the thesis argues that the debate at the Financial Stability Forum embodies too many biases and governance deficits to be considered accountable and representative of all the interests at stake. Contrary to other IPE scholars, who have taken a rather optimistic view of the contemporary discussions on the GFA (Germain 2002), this thesis is pessimistic on the prospects for global financial governance, as it is debated and formulated in a framework that severely limits regulatory solutions. The debate on hedge funds might have been exceptionally unsuccessful (Porter 2001), but it is difficult to see it as the exception instead of the rule for the many arrangements to reform the Global Financial Architecture that proliferated since 1998.

4.5 Conclusion and policy options

This chapter has drawn attention to the coalition of interests that were present at the regulatory table when FSF regulators started discussing the case of hedge funds. On a first approximation, a conflict was identified between emerging-markets on the one hand and the US on the other. The former expected the implementation of tougher controls on hedge funds and requested that those changes be carried out in the US, which was the country where most hedge funds were managed; the latter resisted any changes to the regulatory regime of hedge funds. The chapter has shown how the US authorities could count upon the support of the UK and the Netherlands and on a not too strong opposition from the other FSF constituencies (G-7 countries).

On a second approximation, the US interest had to be further explained. It was argued that the crucial coalition of interests was the one that revolved around US regulators and their regulated communities. Underhill's concept of 'closed policy community' between private and public interests is most suitable to describe this situation. Private financial actors – who do not only include hedge funds, but also banks and large institutional investors – did not formally participate in the work of the FSF Working Group on HLIs, whose membership is

limited to states. Private actors, however, exercised an enormous influence through informal meetings with FSF regulators and their growing authority in domestic regulatory processes. It was pointed out that the interest that prevailed in Basel was largely determined by the preferences of the financial and especially banking community for leaving hedge funds unregulated. This is turn was explained as a consequence of the huge profits that banks make with the business with hedge funds (Chapter 3).

This chapter has then moved to the domestic level in the US and shown how the 'national interest' championed in Basel was aggregated. The analysis of the phases of the debate in the US showed how the preferences of private financial actors prevailed in the US regulatory context. The focus was on the nature and composition of the domestic institutions that addressed the issue of hedge funds and on the rule-making procedures characterising the legislative and administrative initiatives undertaken. Empirical evidence revealed that almost all these initiatives failed to – or never – took off. More to the point, it revealed that the very initiatives taken to change the legal regime of hedge funds were actually carried out to keep hedge funds out of the reach of regulators. This uncovered important aspects of the governance of financial markets. In particular, it showed how the delegation of authority to private financial players has occurred through a corresponding reduction in the legislative and administrative power of public regulators.

Finally, it was pointed out that the institutional setting where the debate took place had an impact on the type of decisions that could be taken. It was shown that rule-making procedures both at the Financial Stability Forum and in Washington largely favoured the coalition of interests described above. The FSF in particular was said to be no more than the sum of domestic contributions – with some contributions weighing more than others.

Overall, the debate in Basel proved to be a regulatory failure. The failure was not only of the particular debate on hedge funds, but also of the entire decision-making process used to

gather consensus in venues like the BIS and the FSF. The limited FSF membership, the unequal allocation of seats, the ambiguous nature of consensual decision-making and the lack of enforcing mechanisms contributed to make the debate appear as a 'brain wash' to accommodate the interests of the US administration and the financial community.

Such an explanation of the outcome of the debate on hedge funds brings us to a clear set of policy solutions. First, the role of emerging markets in venues like the BIS and the FSF needs to be rebalanced. Second, the authority of private financial actors needs to be contained by giving back to public regulators some of the powers that they lost to the financial community or at least by making private actors more accountable to other sectors of society. These solutions, for instance, are embraced by the UNDP.

The UNDP looks at the composition of the Financial Stability Forum and argues that 'at present developing countries are not at all represented in the Forum itself' (Griffith-Jones 2002: 1). As Inge Kaul and Mirjaam Schnupf, respectively Director and Policy Analyst at the UNDP Office of Development Studies (ODS), point out,

> The composition of the concerned policy-making bodies is biased towards participation of the major-market countries and financial-sector experts and policy-makers. The participation and voice of developing countries as well as that of many stakeholder groups is often limited. [...] Broader participation in financial policy-making [...] is a precondition of achieving a balanced global policy regime, one that enjoys the support of all, and therefore, is also likely to be the more effective and efficient one in the longer run (Kaul and Schnupf 2001).

The UNDP proposal is to add six developing countries to the 40 current members of the FSF, chosen on a regional basis: two from Asia, two from the Western Hemisphere and two from Africa. Developing country representatives would be appointed for a relatively short period and then rotate, which is the formula adopted in the Boards of the Bretton Woods Institutions (Griffith Jones 2002: 2). According to the UNDP, 'adding a small representation of developing countries to [the FSF] – would: a) increase its legitimacy, b) increase

developing countries' commitments to its aims and c) add valuable insights and perspectives to its decision-making process' (ibid).

Implicitly, this policy perspective blesses the FSF aims and principles and assumes that a broader participation in it would be beneficial to developed as well as developing countries. This perspective does not problematise the very tenets that this regime rests upon and the meaning of stability, efficiency and participation within this context. The next chapter will look at the structure of meaning within which discussions at the FSF took place. It will show that, without a rethinking of the tenets and concepts of the current system of global financial governance, a further inclusion of other countries and stakeholder groups will only serve to constrain regulatory solutions within the existing framework and make alternative choices harder to bring forward.

CHAPTER 5

THE THIRD EXPLANATORY MODEL:

The Structure of Meaning

5.1 Introduction

The previous chapter looked at the leading position of the US administration in financial affairs and the increasing delegation of regulatory authority from public to private actors as determining factors in the outcome of the debate on hedge funds. It also showed how these two forces were interrelated and self-reinforcing. To begin with, the US regulatory authorities involved in the Basel negotiations opposed any proposal to regulate hedge funds in a concerted way at the international level. They proved equally unwilling to implement any reform at home. Alongside it, the financial and specifically the banking community was adamantly against any reform affecting hedge funds and was able to impose its view in both domestic (US) and international (FSF) fora. The increasing coincidence of interests between regulators and regulated, which for Underhill constitute a 'closed policy community' (Underhill 1997: 24), was assessed.

It was not considered, however, that decisions were taken and recommendations were formulated by drawing on a particular structure of meaning that all actors – developed countries as well as emerging markets – were part of. Interviews with regulators, economists, market commentators and NGO people revealed that there was a 'common ground' or a common set of tools to analyse the problem of hedge funds. This common ground provided *structural limitations* to the kind of problems that could be discussed and to the solutions that could be brought forward. The notion of relational power that dominated the second explanatory model is inadequate to understand these structural limitations. More structuralist notions of power need to be brought into the analysis. This

chapter does this by looking at the power of the structure of meaning or discourse within which the debate took place. This is the essence of the *third explanatory model.*

Following Chapter 1, this model provides a 'regulation-as-discourse' approach to the study of regulatory decision-making processes. This approach draws attention to the ways in which regulatory problems and solutions are created. This is in line with Foucault's theory, according to which the focus should be on problematization rather than on problems (Foucault 1992 [1984]: 10-11). So, by looking at the way questions are raised in the debate on hedge funds, it is possible to explain why certain issues made it to the regulatory agenda while others failed to be formulated as problems. This approach is structuralist as it does not ask 'who' is formulating and imposing a discourse or structure of meaning. As Foucault writes, 'the analysis should not concern itself with power at the level of conscious intention or decision. [...] Instead, it is a case of studying power at the point where its intention, if it has one, is completely invested in its real and effective practices' (Foucault 1980: 97). It follows that discourse will be studied for its concrete effects on policy-making, no matter what its starting point, intentionality or primitive origin is.

Chapter 1 indicates that one way of studying discourse is to look at its tenets or 'co-ordinates of knowledge'[55] not only as mental structures but also in their materiality. So this chapter identifies five main elements or co-ordinates and exposes their materialisation in regulatory practices. The five elements are: (a) confidence in the working of an equilibrium market and its disciplining effect; (b) efficiency as the main criteria to evaluate financial instruments as well as regulatory proposals; (c) financial instability as the main preoccupation of the current market-led system; (d) due diligence as the new form of governance in financial markets – and the main tool to reach financial stability; and (e) and an individualistic idea of risk. These elements complement the idea that hedge funds are

efficiency-enhancers and exceptional and alternative investment vehicles, which was analysed in Chapter 3. The belief in the thorough and effective nature of banking supervision and regulation also had an important bearing on the discussion.

It is also important to make the link with the discussion in the previous section. Chapter 4 argued that the decisions taken in Basel reflected the will of the US authorities and private actors. This chapter said that these decisions also stemmed from a particular understanding of regulation, which revolves around the elements outlined above (efficiency, equilibrium, financial stability, due diligence, individualistic understanding of risk). The two explanations do not have to be seen as separate. As Cox argued, the structure of meaning and the structure of interests go hand in hand in defining a hegemonic project. The interconnection of the 'strategic' and the 'meaning making' is even more forcefully emphasised in the later writings of Foucault and in his concept of discourse as *apparatus* (Chapter 1).

Within this theoretical framework, the chapter analyses the interplay of meaning and strategy as evidenced in the main decisions and recommendations formulated by the FSF Working Group on HLIs. How did this structure of meaning influence regulatory decisions on hedge funds? Which market setting did it privilege? These questions will be raised in section 5.3 through 5.6. Section 5.3 looks at the decision to devote more attention to systemic stability than to market integrity. Section 5.4 analyses the decision to indirectly regulate hedge funds to prevent systemic risk. Section 5.5 looks at the decision not to regulate hedge funds at all to prevent Asia-type crises. Section 5.6 looks at the decisions that were not taken or, more precisely, at the problems that were not formulated. This last section employs the concept of the unsaid, which will be dealt with more thoroughly in the

[55] The phrase 'co-ordinates of knowledge' builds upon Foucault's definition of apparatus. Foucault writes: 'In trying to identify an apparatus I look for the elements which participate in a rationality, a given form of co-ordination [...]' (Foucault 1980: 197).

next chapter. Before moving to the core of the analysis, section 5.2 defines the elements of the structure of meaning and introduces the main recommendations of the FSF Group.

5.2 The elements of the structure of meaning

This section looks at the defining elements of the structure of meaning or discourse before discussing the way in which this structure contributed to the shaping of the regulatory problem of hedge funds. As said above, the rules that inform this structure will be identified both as systems of meaning and of social and economic relations. This means that concepts of equilibrium, stability, due diligence and individualism will be traced in economic theories as well as in regulatory and market practices. As the concept of efficiency has been thoroughly analysed in Chapter 3, this section only analyses the other four tenets and refers to Chapter 3 for a discussion on efficiency.

The first element is the idea of equilibrium. The general or one-equilibrium economics is the foundations of any model, proposal, or view that can be entertained in circles like the FSF. The concept of multiple equilibria[56] – that is, the idea that markets might not converge to a unique equilibrium, but get caught in multiple paths – is partly accepted in policy circles such as the UNDP, but is considered an impracticable view of the world at the Financial Stability Forum and the Bank for International Settlements (Anonymous 9, interview 2003). This orthodox resilience has direct practical implications. For instance, the strenuous defence of short selling that will be reported in section 5.3 comes from the idea that markets will always achieve equilibrium and that distortions are only temporary.

The second and third elements of the structure of meaning, respectively the emphasis on financial stability and due diligence, will be analysed together, as they are closely

[56] There are different definitions and applications of the concept of multiple equilibria. For a multiple equilibria approach to the study of financial crises see for instance Masson 1999.

interrelated. Financial stability has become one of the most debated concerns in finance and has catalysed a variety of initiatives (Financial Stability Forum, Financial Stability Institute, etc.). It has also been promoted as a global public good (GPG) by the UNDP. It is no exaggeration to say that financial stability has become 'the' concern in discussions of the global financial architecture. The prevention and management of any sort of market failure and crisis have been included under its heading.

This is apparent in the agenda of two major agencies that have worked on this issue, the FSF and the UNDP. The UNDP defines financial stability in terms of its opposite, financial instability, and associates the latter with any kind of financial crisis – currency crises, banking crises or both together (Conceição 2003). The UNDP has promoted financial stability as 'the' global public good of finance, together with market efficiency (Griffith-Jones 2003). The creation of the Financial Stability Forum reflects a similar set of concerns. The events of 1997 and 1998 – Asian financial crises, emerging market turmoil and near-collapse of LTCM – prompted G-7 finance ministers and central bank governors to create the FSF. Even in this case, concerns for financial crises and market failures of different kinds were subsumed under the heading of financial stability. But what is so appealing in the idea of stability?

Stability recalls the idea of equilibrium, a stationary state where things are perfect the way they are. It becomes crucial, therefore, to understand what regulators want to keep stable. As Andrew Crockett points out, concerns for financial instability rose with the resurgence of a market-led, as opposed to a government-led, financial system. It is only when this resurgence was complete (at the end of the 20th century) that episodes of financial instability became more prominent. Mr Crockett takes LTCM as an example of an episode when market discipline broke down (Crockett 2001). Mechanisms to ensure financial stability thus become the counterbalancing effect of having an increasingly market-driven regulation.

In other words, the stress on financial stability is a direct consequence of a financial system that increasingly relies upon private actors' due diligence in order to remain sound.

At the same time, when measures to achieve financial stability are discussed, they are made dependent upon responsible behaviour (due diligence) by each player in the market. In circular reasoning, the cause of instability and the restoring of stability are made identical: reliance on private actors' self-assessment of risk. It is here that due diligence becomes tightly linked to financial stability and regulators tightly dependent upon the behaviour of regulated institutions.

Since at least the 1970s, a whole structure of meaning has given sense to projects and recommendations directed at enhancing market discipline while at the same time making a government-led system most unlikely to either reappear or to be integrated with the market-led one. It was not simply a question of theories and ideas, but of a very 'apparatus', according to the definition given in Chapter 1, made up of financial concepts, models, instruments, strategies and institutions. Huge resources have gone into perfecting private actors' self-assessment of risk, e.g. the models of risk internally used by banks, which are then the basis upon which their supervision is carried out. The regulators' idea is that, if banks perform due diligence in assessing and hedging risk, they will remain solvent and along with them the whole financial system will be sound and stable. Banks' supervisors can only assess whether banks' models make sense and whether banks stick to these models, but no innovations or suggestions come from the official sector. In general, very few resources go into the public sector to devise regulatory solutions that are independent of private actor preference and expertise. As a consequence, regulators are unlikely to have the will, skills and experience to act in opposition to what private market actors want.

The emphasis on financial stability, therefore, has to be seen against an apparatus that is programmed to work according to due diligence and self-regulation. Chapter 4 pointed out

that issues of financial stability are privileged because they are the ones that most interest FSF constituencies. They are also the ones that financial economists and regulators are most (or only) capable of dealing with.

The last feature of the structure of meaning refers to the fact that risk in finance is understood in rather individualistic terms. This might sound like a contradiction, given the fact that the whole debate on financial stability is based on the idea of *systemic* risk. The statutory objectives of the Financial Stability Forum, for instance, are to 'promote international financial stability, improve the functioning of markets, and reduce systemic risk' (FSF 1999). However, a look at the current usage and context of the term 'systemic risk' justifies this argument.

Systemic risk is supposed to include those financial risks that affect the 'system'. For regulators and supervisors this mostly means preventing the contagion of financial troubles from one firm to the other. The way they usually go about this is by supervising the risk management system that each institution has in place and to impose higher capital ratios for riskier activities. In this way, they hope, if not to restrict the risk taking ability of financial institutions, at least to get them to hedge for the risk they take. The rationale is that if each institution is solvent, the whole system will be stable. This way of conceiving of systemic risk raises two main questions. First, it raises the question of whether this supervision is effective for the purpose of preventing domino-type contagions. Second, it raises the question of whether this is the only financial systemic risk that regulators (and society) should prepare for.

As for the first question, Section 5.2 pointed out that private actors elaborate the models of risk upon which their risk management system is assessed. In principle, they are able to 'cheat' if they want to: their skills and resources make them more powerful than their supervisors. Preventing systemic risk thus becomes a difficult task both because of the

complexity of firms' risk models and, even more importantly, because, 'no firm has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms' (PWG 1999: 31). To overcome the complexity problem, regulators have started delegating more and more of their functions to private actors, which means that risk control functions are even more relocated at the level of each individual firm. This move, however, will further exacerbate the incentive problem.

It is the second question, however, which best underlines the individualistic understanding of risk. According to the definition of systemic risk adopted by regulators (Section 5.2) the prevention of systemic risk consists in making sure that all market participants cover for the risk they individually take. Making a parallel with environmental studies, it would be like asking polluting companies to protect themselves for the risk they take. But what about their impact on the broader environment and on non-companies? This suggests that this definition of risk is not truly systemic. In addition, systemic risk is largely linked to the occurrence of a crisis, which is intended as a sporadic and dramatic event that suddenly breaks out. Making another parallel with environmental risk, it would be analogous to focusing all worries on the occurrence of another Chernobyl without considering the day-to-day effects of pollution and the necessity of the reduction/elimination of nuclear waste. This is exactly what happens in finance: the day-to-day effects of financial speculation are rarely (if ever) studied and even more rarely considered for the risk they pose in terms of wealth loss (e.g. Internet bubble) and redistribution of wealth across society. Altogether, these considerations support the argument that risk in finance is conceived in individualistic terms.

These four elements (plus efficiency) make up the structure of meaning within which regulatory discussions took place. They are complemented by the representation of hedge funds as efficiency-maximisers and exceptional and atypical investment vehicles, which was discussed in Chapter 3. The belief in the thorough and effective nature of banking supervision had an important bearing on the discussions too. Altogether these elements

contribute to explain the way the hedge fund problem was framed and recommendations were formulated, which will be the subject of the following four sections. These sections show how the way of raising questions and framing problems in a regulatory setting does not correspond to any natural logic of the kind 'the problems regulators are faced with' – what Shapiro calls the 'passive grammar of decision-makers "faced with problems"' (Shapiro 1992: 99) – but is constructed to exclude certain issues from public discussion.

As we saw within the introduction, the explanation given in this chapter has to be considered jointly with the explanation in Chapter 4: the outcome of the debate depends on the distribution of power at the regulatory table and on the structure of meaning within which discussions took place. The message of this chapter, however, is that in order to change the former (distribution of power), it is necessary to change the latter (structure of meaning). Before proceeding with the explanation, Table 5.1 summarises the main recommendations of the FSF Working Group on HLIs.

Table 5.1 – FSF Report: main recommendations

Recommendations	**Pillar 1 or 2**	**Addressing hedge funds**	**Addressing hedge funds' counterparties**
(1) Stronger counterparty risk management	1		X
(2) Stronger risk management by hedge funds	1	X	
(3) Enhanced regulatory oversight of HLI credit providers	1		X
(4) Greater risk sensitivity in bank capital adequacy regulation	1		X
(5) Sustaining industry progress	1		X
(6) Building a firmer market infrastructure	1		X
(7) Enhanced public disclosure by HLIs	1	X	
(8) Enhanced public disclosure practices generally	1		
(9) Enhanced national surveillance of financial market activity	2		
(10) Good practice guidelines for foreign exchange trading	2		

Source: FSF 2000: 2-4.

Eight out of ten recommendations are concerned with the first pillar (systemic stability) and only the last two are concerned with the second one (market dynamics and integrity). In addition, only two recommendations directly concern hedge funds (2 and 7),[57] while most of the efforts are targeted at hedge funds' counterparties (banks, securities firms, prime brokers), which are devoted at least 5 major recommendations. Four main conclusions can be drawn. First, the space and attention devoted to the first pillar is much greater than that devoted to the second. Second, the FSF Working Group ruled out any *direct* regulation of hedge funds and greatly relied upon hedge funds' counterparties (mainly banks) to *indirectly* regulate them. Third, hedge funds were not considered in need of regulation for the role they allegedly played in the Asian crisis: indeed, the two recommendations that concern the second pillar do not tackle hedge funds but rather domestic financial systems. Fourth, the debate has overlooked a whole series of issues and questions that lie outside the two core pillars. These four points will be developed in the following four sections.

5.3 Two pillars but only one debate

Chapter 4 already pointed out that the first pillar, systemic stability, was given more attention than the second one, market dynamics and integrity (Chapter 4: 184). Table 5.1 only confirms it: eight out of ten recommendations deal with the LTCM-type of problem, while only two recommendations address the Asian-crisis type of concern. Chapter 4 argued that this is because market integrity is not a concern for the US and G-7 countries, which are the FSF constituencies. This is unquestionable: in fact no regulatory debate on hedge funds would have taken place if it were not for the LTCM near-collapse, that is, for a market failure directly affecting an advanced market. The reason, however, goes beyond the direct and overt conflict of interests between developed countries and emerging markets.

[57] Number eight targets market practices in general, and thus concerns all financial institutions, not only hedge funds.

The two pillars of the debate can be briefly summed up in: (1) concerns with the sudden liquidation of a highly leveraged fund and the knock-on or domino effects that this can have on the financial system; and (2) concerns with the impact of aggressive trading strategies and the accumulation of large and concentrated positions in small open economies, emerging markets in particular. The former were said to be issues of systemic stability, while the latter were said to be issues of market dynamics and integrity. The stability of the system, in other words, was made dependent upon the prevention of LTCM-type failures. Though financial stability is in principle defined as including any kind of financial crises, in concrete terms it is not: in the FSF debate, the role of hedge funds in currency crises in emerging markets is taken out of the stability heading. This had two major consequences. First, given the importance that is currently attributed to financial stability, this decision automatically relegated concerns for market dynamics and integrity in emerging markets as secondary problems. Second, it was like saying that crises like those affecting Asia in 1997 were not within the agenda of the FSF. Neglect for the second pillar could have been justified by saying that it was outside the FSF priority areas, which is what partly happened in the course of the Basel debate. As Andrew Crockett said, 'the FSF was there primarily for issues of systemic stability; its terms of reference are on systemic stability; [...] and many countries were not concerned about market integrity, as it does not affect their markets' (Crockett, interview 2003). This shows how the enormous emphasis that is currently devoted to financial stability serves to keep other issues and concerns outside the policy agenda. It also shows that the naming of problems is never politically neutral.

The same change of name from 'hedge funds' to 'highly leveraged institutions' (HLIs) has to be interpreted as another effort to promote the first pillar at the expense of the second. There was certainly the need to stress that hedge funds are more numerous than a couple of macro Soros-type funds and thus a change of name might in principle be desirable. Yet the choice of name was not dictated by technical necessity. The changed name implies that

hedge funds and equivalent vehicles raise concerns because of the high levels of leverage they can accumulate. This, however, only accounts for half of the problem. Hedge funds can raise concerns even when they do not accumulate high levels of leverage. As the FSF report acknowledges, reduced leverage may not be enough to address the concerns of small open economies, as '[e]ven with reduced overall leverage, HLIs could still build large foreign exchange positions relative to these markets' (FSF 2000: 39). In other words, high leverage is a concern for LTCM-type crises, but not necessarily for what happened in Asia in 1997. The re-naming of hedge funds as 'highly leveraged institutions' was a further way of disfavouring the second pillar.

To conclude, both the name of the venue – the Financial Stability Forum – and the re-naming of the regulatory problem – highly leveraged institutions – were biased towards a certain outcome from the outset. This shows how any choice of target, of grammar and of vocabulary is a political choice that presupposes a well-defined market and regulatory philosophy – in this case one that is associated with neo-liberal ideas.

It might be objected that this perspective does not add anything to the second explanatory model, according to which systemic stability is preferred over market integrity because this is what concerns FSF constituencies. Whereas the immediate conclusions might not change, the policy responses can be profoundly different. Instead of calling for a larger participation of developing countries into the Financial Stability Forum (UNDP proposal), a perspective that accounts for the structure of meaning would call for a different venue and different core principles before starting any negotiation. This is because the very fact of focusing on stability and being hosted by an institution that is called the 'Financial Stability Forum' (under the conditions outlined above) might rule out concerns for equity and democratic accountability. Now that the FSF and other related institutions are in place, they are perceived as the proper venues to discuss major problems of global finance (Germain 2002).

Their original bias, however, will always undermine efforts to go beyond the narrow focus of financial stability.

5.4 First pillar: hedge funds are best to be ' indirectly' regulated

The debate on the first pillar largely revolved around the concept of 'indirect regulation'. Indirect regulation was intended as a means to produce compliance effects through disclosure and self-diligence by hedge funds and especially by their counterparties. In other words, it was intended as a means to produce compliance in a non-mandatory way.

The concept of indirect regulation can be traced back to many of the tenets analysed above: first, the assumption that financial stability is produced by the responsible behaviour of individual players (due diligence); second, the assumption that banks and other counterparties have an interest in preventing hedge funds from causing market disruption; third, following from the second point, the assumption that hedge funds' counterparties are different and detached from the hedge fund industry; fourth, that the banking sector is properly supervised and regulated; and fifth, that systemic risk is a function of individuals taking care of their solvency. All these assumptions will be critically analysed at the light of the empirical evidence collected through interviews and secondary documents.

5.4.1 Indirect regulation through disclosure and self-diligence by hedge funds

Section 5.2 showed that few recommendations directly tackled hedge funds (only two out of ten) and that most of the attention turned to hedge funds' counterparties (five out of ten recommendations). Even the two recommendations that specifically target hedge funds – both within the first pillar – do so in a very *indirect* way, through what Crockett calls 'a non-mandatory approach'. The first recommendation calls for *improving risk management standards* in the hedge fund industry and the second for *enhancing public disclosure by HLIs.*

For the first recommendation, the FSF Working Group relied to a great extent upon the *Sound Practices Report* prepared by a group of five big hedge funds. This report elaborates a set of sound practices for risk management in the hedge fund industry. In particular, it stresses the importance of adopting appropriate measures of leverage (risk-based and not only accounting-based) and liquidity; of taking into account a broader range of risks (including operation risk, liquidity risk, legal risk, and so on); of setting up appropriate internal controls; and of disclosing the fund's risk profile to counterparties. These guidelines were intended to prevent the building up of high levels of leverage and the recurrence of another LTCM (Sound Practices 2000).

In terms of implementation, none of the five hedge funds that drafted the report managed to adopt all of their own recommendations (Temple 2001: 187), despite the fact that they should be an example for the rest of the industry (FSF 2000: 25). This is without considering that, even in case of full implementation, the recommendations in the Sound Practice Report would have not brought about any major structural change to the industry. The non-disclosure of proprietary information, for instance, is strenuously defended (Sound Practices 2000: 24). Finally, the report was written by a group of macro funds and not by market-neutral funds such as LTCM. It was easier for them to stress the exceptionality of the LTCM case and say that hedge funds do not usually accumulate such high levels of leverage. Global macro funds, in fact, operate in different contexts, where positions can be accumulated even without high leverage (Section 5.3: 9). It is easy to agree with Peter Temple when he notices that the Sound Practices Report 'seeks to apportion blame elsewhere, while the recommendations are flawed because of the proviso relating to keeping proprietary information secret no matter what' (Temple 2001: 187).

Thus the assumption that financial stability is produced by the responsible behaviour of individual players is weak. It would be naïve to expect this group of hedge funds to impose

too-burdensome measures upon the industry. They write in the belief that 'the most effective form of oversight is self-evaluation combined with self-discipline' (Sound Practices 2000: 28). In other words, they want to keep regulators away from their industry. On the other hand, regulators seem to be all too willing to delegate controls to the very actors they need to supervise. As the FSF report writes, 'the FSF welcomes the steps taken by the hedge fund community' (FSF 2000: 25). Rather than a policy response, this FSF recommendation looks like a note to welcome the initiative and endorse the principle of 'self-assessment of risk' (Underhill 1997: 18) and self-regulation.

The second recommendation calls for better information on HLIs as a complement to stronger risk management practices and to 'enhance the operation of credit and market discipline' (FSF 2000: 29). Three options were *considered*:

(1) Enhanced reporting to supervisors and regulators by HLIs' counterparties;

(2) Confidential reporting by HLIs to authorities;

(3) Public disclosure by HLIs.

The first option was suggested by the Counterparty Risk Management Policy Group (CRMPG), which said that counterparties, if requested by their regulator, should voluntarily provide information on their largest exposures, including exposures to HLIs (CRMPG 1999: 54; FSF 2000: 29). Yet the CRMPG also voiced a number of practical difficulties and limitations that made the option appear as unfeasible. First, the CRMPG said that it is difficult to aggregate exposures that arise from different market products, which are under different legal treatments. Second, it is difficult to determine the exposure to any one firm, as there are a large number of underlying contracts being combined and netted. Third, complication would be even greater for any attempt at aggregating such information across counterparties. Fourth, given the global nature of markets, looking at the exposures of only domestic participants will not be enough. Regulators will need to request *global exposure reports*, which in turn would require developing the systems and personnel necessary to

process this additional information as well as to create international information sharing agreements. Fifth, there is the risk that institutions, knowing that regulators receive information on exposures to HLIs, would reduce their own risk management system and rely upon a politics of bailouts (moral hazard). The CRMPG was also adamant on the issue of confidentiality. Should this information be collected, they said, it could not be made public (CRMPG 1999: 50-55). Given all these limitations, the CRMPG concludes that the best recommendation is to delegate any risk concern to counterparties and calls for 'increased discipline on the part of regulators to limit tendencies to interfere in matters best left to management' (ibid: 50).

The US representatives opposed a similar proposal for reporting by counterparties, which was advanced by the German delegate at the FSF Working Group on HLIs. When Dietrich Jahn[58] proposed to set up an *International Credit Register* to gather information on credits and exposures to HLIs (FSF 2000: 33), the US representatives opposed it for the same reasons of unfeasibility raised by the CRMPG. Yet Frédéric Visnovsky of the French representation[59] pointed out that the issue of unfeasibility was not that strong in the case of the International Credit Register. 'Meaningful data, he said, can be collected. Data that goes to a credit register do not change too fast and even if they arrive late, they can still be very useful' (Visnovsky, interview 2003).

The second option – HLIs to report directly to regulatory authorities – was dismissed by the FSF Working Group. The Group was not convinced that this was the best way to tackle systemic risk, especially as supervisors/regulators 'might not have the same level of resources available to analyse such information as some financial market participants' (FSF 2000: 30). Another argument was that regulators might not have the mandate to process the

[58] German delegate to the FSF Working Group on HLIs. See Appendix 2.
[59] Mr Visnovsky was the alternate of Jean-Pierre Patat, the French representative at the FSF Working Group on HLIs.

information received by HLIs (same point as in Section 4.3.2): for this reason they prefer not to receive it at all, so as not to give rise to unjustified expectations (moral hazard) (ibid).

The third option, public disclosure, was recommended by the PWG and IOSCO (FSF 2000:31). The FSF Working Group recognised that public disclosure *would be desirable*, but once again it acknowledged its limitations: (1) data can become soon outdated, (2) information might not be understood properly (see what was said for option one and two); and (3) it is difficult to release information without disclosing proprietary information. The FSF welcomed the proposed US legislation to achieve public disclosure of hedge funds and called on other jurisdictions to do the same. The reference is to the Hedge Fund Disclosure Act, the Derivatives Market Activities Act and the proposed new rules for Commodity Pool Operators reporting to the CFTC (Chapter 4: 194-199). The FSF also welcomed a study carried out by the Multidisciplinary Working Group on Enhanced Disclosure (MWGED 2001), which deals with disclosure enhancement for a broader range of financial institutions (banks, insurance companies, securities firms, mutual funds, hedge funds, etc.). Chapter 4, however, showed that the US initiatives did not progress according to the FSF expectations. The Hedge Fund Disclosure Act and the Derivatives Market Activity Act were not enacted (Section 4.3.2) and the CFTC change of rule was not implemented. For what concerns the public disclosure rules elaborated by the MWGED, progresses in their implementation have been scant. In its 2002 follow-up notes, the FSF writes that 'it is not clear whether [hedge funds] or regulated firms have begun to implement [the MWGED] recommendations' (FSF 2002: 7).

These considerations evidence that the indirect approach did not work. The idea was to combine disclosure of information on HLIs, so as to enhance the working of market discipline, with due diligence by HLI managers. Market discipline, however, works when information is perfectly available, financial players produce and circulate that information and then, on the basis of that information, rationally take their decisions. This theoretical

model is not equipped to include issues such as non-compliance, total lack of data, and, above all, the strenuous defence of confidentiality in the financial community. As Anonymous 1 observed, 'the US defended the choice of transparency and disclosure as superior to any more mandatory approach. Yet its financial community is the most concerned with issues of confidentiality' (Anonymous 1, interview 2003). For example, both the CRMPG and the Hedge Fund Report were adamant about the non-disclosure of proprietary information. Non-disclosure of proprietary information, however, greatly limits the working of market discipline. For instance, although LTCM was reporting VAR information before its collapse, it did not include proprietary data. Without these data, it would have been difficult to know which risks its VAR models referred to (Adams, interview 2003).

Due diligence, on the other hand, works when financial players and regulators share the same interests and objectives. Due diligence presupposes that it is in the self-interest of each hedge fund to enhance risk management practices to prevent insolvency and failures. Financial players, however, might not share this view, if it is true that even the 'group-model' of hedge funds did not implement all of their recommendations (Temple 2001:187). Even if they did, the scope of these recommendations would have been nevertheless limited (Section 5.4.1: 12). Therefore, 'one must conclude that the hedge fund industry is congenitally incapable of reforming itself in any meaningful way' (Temple 2001: 187). This observation discards the primary tenet of the working of due diligence: self-interest is not always conducive to the best outcome for the market and society. In brief, all the assumptions upon which indirect regulation of hedge funds through disclosure and self-diligence was based proved to be flawed.

5.4.2 Indirect regulation through the banks

The indirect approach, however, was principally used towards hedge funds' counterparties. As we saw at the beginning, five out of ten of the FSF recommendations are specifically

targeted at banks and hedge funds' counterparties in general. FSF regulators treated them as the core policy options (FSF 2000: 21). This choice stemmed from the consideration that 'HLIs accumulate leverage and undertake positions in financial instruments through credit providers and intermediaries – principally banks and securities firms' (ibid: 21-22). Additionally, counterparties are subject to regulatory oversight. As Svein Andresen of the FSF Secretariat in Basel summarised,

> 'One felt that in order to obtain leverage hedge funds were totally dependent on credit providers, who were *regulated providers*, over which authorities had power. A more powerful means was to ask regulatory authorities to restrict them instead of hedge funds' (Andresen, interview 2003, my italics).[60]

Many reasons were given to justify indirect regulation through counterparties. First, it was argued that it would be extremely difficult to regulate hedge funds directly, as they can be easily redefined and relocated out of supervisory reach (Brockmeijer, interview 2003, Crockett, interview 2003). More generally, as the definition of hedge funds is problematic, it would be difficult to decide which vehicles or strategy should be subject to regulation (Andresen, interview 2003). Second, it was felt that direct regulation would have required addressing the issue in a concerted way, which was deemed impossible: 'there would be practical difficulties unless all countries including offshore centres do it together, and there is no way you can get everyone to do it' (Andresen, interview 2003). Third, there is a question of moral hazard: 'do you want as a central bank to be seen taking responsibilities for hedge funds' (Brockmeijer, interview 2003)? Finally, hedge funds were seen as performing the important function of enhancing efficiency and bringing liquidity to the market (Chapter 3), and it was argued that any regulation could have hampered this role (Brockmeijer, interview 2003).

Chapter 3 problematised these arguments, especially the efficiency-enhancing one and the fact that hedge funds can move offshore. Beyond these official justifications, it became

[60] Svein Andresen of the FSF Secretariat was the most involved BIS official in the drafting of the FSF report. He also wrote the Tietmeir report, which is a sort of antecedent of the FSF 2000 report.

apparent that indirect regulation was privileged because it better fitted a market-led regulatory setting. In other words, tackling hedge funds' counterparties was deemed to be the best solution to make market discipline (instead of regulators) work. It was deemed in the self-interest of credit providers to obtain enough information to assess the risk of dealing with leveraged institutions and to price this risk appropriately: if the risk were too high, credit would be reduced or withheld.

Four recommendations particularly fulfil this purpose:

1. the first recommendation is to strengthen counterparty risk management;
2. the second to enhance regulatory oversight of counterparties;
3. the third to make bank capital adequacy regulations more sensitive to the risk involved in dealing with HLIs;
4. the fourth (which can be read jointly with the first) to sustain industry progress in improving specific areas of the risk management practices of counterparties;

The first recommendation is central to the entire FSF report. It says that counterparties – commercial and investment banks, brokers/dealers and securities houses – have to improve the management and assessment of the risks they take when dealing with HLIs (FSF 2000: 22). If these firms are able to exercise discipline upon HLIs, all the calls for public disclosure and direct regulation of hedge funds are no longer imperative. This kind of discipline did not work in the case of LTCM, when banks did not pay attention to the mounting leverage and illiquidity the fund was undergoing. To introduce or re-establish it, a series of measures were envisaged. In particular, counterparties were expected to: (a) request adequate information to assess the risks HLIs are taking; (b) tighten their risk management systems – e.g. refining their measurements of risk, such as the measurement of

potential future exposures (PFE),[61] developing better stress testing methods, improving the measurement of liquidity risk and factoring illiquidity in VAR models; (c) increase the price of their services, including lending, to reflect the risk of transacting with HLIs – e.g. tighten margin and collateral requirements; (d) limit the level of business with HLIs and in general review the opportunities of doing business with large, opaque institutions (ibid: 22-23).

To improve risk management practices in the industry (fourth recommendation), the FSF relied once again upon the Counterparty Risk Management Policy Group (CRMPG). The FSF envisaged a process of policy transfer of best practices implemented by the CRMPG (the leading firms) to the other firms in the industry. The FSF report writes: 'Changes at individual firms are essential adjustments and fundamental to containing the risks presented by HLIs' (FSF 2000: 22). This shows once again that systemic risk is intended as a function of individuals taking care of their solvency.

Private actors alone, however, were not considered enough. One of the reasons to target counterparties was that they are regulated and supervised. As the FSF report writes, improvements in risk management have to go hand in hand with better supervision and monitoring by supervisors and regulators – e.g. they have to monitor the extent to which regulated institutions comply with the above-mentioned set of sound practices. This is the subject of the second recommendation: *enhancing oversight of hedge funds' counterparties* (ibid: 25).

Regulators are called to strengthen their supervisory and regulatory oversight of counterparties by: (1) intensifying oversight of those regulated institutions that fall short of sound practices; (2) asking counterparties to provide periodic affirmations of this compliance; (3) restricting the ability of firms to do business with HLIs (only as an extreme

[61] The point on potential future exposure measurement is quite important: apparently, the only thing that was measured at the time of LTCM was the actual exposure, without taking into account that

measure). Regulators should also make a greater use of the supervisory review process as set out in the New Basel Accord (Basel Committee on Banking Supervision 1999) in order to assess the adequacy of capital in relation to the quality of risk management.

This is part of the third recommendation to counterparties: *strengthening the linkage between risk and capital requirements* (FSF 2000: 26-27). With reference to banks, this is explored in Pillar II of the New Basel Capital Accord (Basel Committee on Banking Supervision 2001), which is currently under discussion.[62] This document is expected to deal with all sources of credit to HLIs, including OTC derivatives and repurchase agreements, the two major sources of banks' exposure to HLIs. The FSF Working Group does not recommend that Basel II includes a specific provision for transactions with HLIs, but that it makes sure that banks lending to institutions about which they have inadequate information have capital requirements well above the regulatory minimum (FSF 2000: 27). In a similar way, the FSF encourages securities regulators to consider the revised accord and apply it to the case of securities firms (which are already asked to maintain sufficient net liquid assets). A separate study by the Basel Committee and IOSCO was prepared with the purpose of harmonising regulation in the two industries (Basel Committee on Banking Supervision and IOSCO 2001).

These recommendations were at the core of the FSF agenda on hedge funds. The whole FSF report indeed revolved around the idea of monitoring hedge funds through the relationships they entertain with *regulated* institutions. The implicit assumptions were that:

(1) counterparties are adequately regulated and supervised in relation to their business with HLIs and

(2) counterparties and regulators share the same agenda.

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market valuations can abruptly change.

[62] Pillar II deals with the supervisory process.

Are these assumptions tenable? They will be tested in the case of commercial and investment banks, which are the main hedge funds' counterparties.[63] A caveat is important here. In this debate, the words 'regulation' and 'supervision' are often used interchangeably. In concrete, the word supervision would be the most appropriate. Banks in fact are under the *supervision* of central banks or national agencies. This means that banks propose a risk management plan and regulators approve and monitor it. Regulatory measures, however, which supposedly are more stringent and pervasive, co-exist with supervisory ones. In fact many reports (e.g. FED Trading Manual) talk of both supervision and regulation. This seems to be the wisest solution, since the line between regulation and supervision is blurred.

Starting from the first assumption, is banking supervision effective for the purpose of monitoring banks' exposure to hedge funds, deterring banks from providing hedge funds with too much leverage, and discouraging banks from entering into too risky activities themselves? Chapter 3 pointed out that the nature of the contracts banks enter into with hedge funds makes effective supervision extremely difficult. Banks do not simply lend money to hedge funds – a rather straightforward operation. They mainly provide them with credit through securities lending and derivative transactions. Chapter 3 described how securities lending gets particularly complex with the use of *reverse repurchase agreements* and *contracts for difference* (CFDs), which are both means to quickly and cheaply leverage hedge funds' capital. It was also described how hard is for supervisors to track the many ways by which assets are used as collateral for different transactions and what this implies in terms of risk. Given these constraints, can supervisors know the nature and extent of banks' activities with hedge funds?

To begin with, supervisors cannot exercise control by relying upon the information banks release to the public (annual reports, etc.). This is because data on banks' transactions with

[63] The largest prime brokers and securities firms for the hedge fund industry are often part of commercial and investment banks, so that banks are representatives of hedge funds' counterparties in

hedge funds are either buried in larger categories such as net interest, securities fees, etc. or are not reported at all. Supervisors might be equally unable to exercise this control by relying upon the information that banks confidentially disclose to them. This is because information on each transaction and customer (name by name) is not available, unless the bank has a large exposure to one single client (e.g. a large amount of money held by one single customer), in which case it has to report it. As an official at the FSA in London says, 'if a bank back in the late 1990s had lent lots of money to LTCM, the large exposure form would have revealed it' (Treitel, interview 2003). What happened to LTCM, however, shows that there are ways to circumvent this rule – or at least that large exposures can take forms that go unnoticed to supervisors. Outside large-exposure cases, information about banks' clients is precluded, as it is part of a bank's confidentiality clause. What regulators are able to know is the *total net exposure* by a counterparty, which means the total exposure a bank has to a hedge fund after all its transactions with it (repurchase agreements, contracts for difference, derivatives, etc.) have been combined and netted (Siddique, interview 2003). This is deemed sufficient to make sure that banks 'do not lay off risk', that is, they measure and control risk properly and put aside enough capital for it (ibid). However, 'there is no certainty that the netting is capturing all the risks' (Anonymous 14, interview 2003). Other important information that regulators miss is the aggregate exposures to any single hedge fund *by all its counterparties*. The previous section mentioned the lack of aggregate statistics on banks' credit exposures to hedge funds and how the German proposal to develop such statistics (with the creation of an International Credit Register) failed to be implemented (FSF 2000: 8).

These considerations suggest that banking supervision might not be effective for the purposes described above (page 24). This negative judgement clashes with one of the most entrenched ideas in finance, the idea that banks are the most tightly regulated institutions in the financial domain. To further challenge this idea, the remainder of the section will go into

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many respects.

further detail about the practice of banking supervision. By drawing on the empirical evidence collected during fieldwork in Washington, Basel and London, the analysis will be divided in two periods, each describing the situation before and after the regulatory changes produced by the near-failure of LTCM. As changes mostly occurred in the US system, the discussion will inevitably move to the domestic level in the US.

According to Allen Frankel, former FED official and now Head of Secretariat of the G-10 Committee on the Global Financial System (CGFS), LTCM exposed a series of deficiencies in banks' risk management policies. When supervisors started inquiring into banks after LTCM, they came across several failures in banks' risk management. First, they found that banks provided information that is hugely diverse in character. The potential future exposure measure (PFE), for instance, was calculated in different ways by different banks (when it was calculated at all). Second, banks did not collect good time-series data, partly because bonuses in banks are too short term to reward the building-up of a long-term value databases. Third, limitations were evident in the measurement of risk, such as in VAR calculations. Fourth, hedge funds were too good as clients to question the trades with them (Frankel 2003).

Mr Frankel argues that things have changed since LTCM. Both the PWG and the FSF recommendations have been effective in inducing banks and supervisors to pay more attention to the quality of risk management. First, he says, 'in the US post-LTCM world, the ability of banks to disregard supervisors has diminished, so that supervisors have more power in redirecting banks towards desired risk management policies' (Frankel, interview 2003). Second, supervisors have improved their assessment of risk. The FED policy in terms of banking supervision has indeed been reviewed to emphasise the importance of banks' due diligence in dealing with hedge funds. The Federal Reserve *Trading and Capital Market Activities Manual*, for instance, now includes a new section on the specific risks that banks face when dealing with hedge funds (Fed Trading Manual, March 1999: 2020.1, p.

10). Regulators have also broadened their classification of risk by accounting for a whole new variety of risks. The Federal Reserve now lists 7 different types of risk: in addition to market and counterparty credit risk (which has nevertheless been revised), there is a funding-liquidity risk (introduced in September 2002, FED Trading Manual Supplement 8–September 2002), a market-liquidity risk, an operations and systems risk, a legal risk (revised after the LTCM debacle in 1998), and a reputational risk (FED Trading Manual, February 1998: 1000.1, p. 2).[64] Also, supervisors/regulators seem to be more wary of large exposures and capital requirements than they were before 1998 and 'banks now recognise that there are sources of revenues and fees, but also potential risks in dealing with hedge funds' (Anonymous 14, interview 2003).

Outside manuals, however, it is difficult to say if something has really changed. There are reasons, in fact, to be less optimistic. Other BIS officials argue that the capacity of supervisors to get a grasp of banks' activities with hedge funds should not be overestimated. (Anonymous 6) argues that supervising banks' transactions with hedge funds can be part (a small part) of the supervisory process, but in any case it is not a high level inquiry. 'It is more an issue of credit risk management by banks than the job of supervisors: it is impossible to supervise these aspects' (Anonymous 6, interview 2003). In addition, he points out that exposures to hedge funds are really quick. Sometimes banks do not even know who the counterparty is (e.g. for certain swap agreements). In repurchase agreements they know the counterparty, but not if it is a hedge fund (in the sense that they do not know

[64] Market risk is defined as the risk that the value of a financial instrument or portfolio of financial instruments will change as a result of a change in market conditions. Counterparty credit risk is defined as the risk that a counterparty to a transaction fails to perform according to the terms and conditions of the contract. Funding-liquidity risk is defined as the risk of not being able to meet investment and funding requirements arising from cash-flow mismatches. Market liquidity risk is defined as the risk of being unable to close out open positions quickly enough and at a reasonable price to avoid adverse financial impacts. Operations and systems risk is defined as the risk of human error or fraud or the risk that systems will fail to adequately record, monitor, and account for transactions or positions. Legal risk is defined as the risk that a transaction cannot be consummated because of some legal barrier. Reputational risk is defined as the risk arising from negative public opinion regarding an institution's products or activities. These definitions are specific to the Fed Trading Manual.

its legal regime). Moreover, 'different people do the trade for the same institutions: how is it possible to know about a huge number of trades that are executed by so many people' (Anonymous 6, interview 2003)?

Further obstacles concern the case of investment banks. It has to be remembered that in the US the Federal Reserve and other banking regulators (e.g. the Office of the Controller of the Currency)[65] have jurisdiction over commercial banks but not over investment banks. Investment banks such as Morgan Stanley and Goldman Sachs are not subject to banking supervision. They are under the jurisdiction of the Securities and Exchange Commission (SEC), but only for what concerns their broker/dealer activities. Anything that is put outside the broker/dealer activity is not supervised. For instance, Goldman Sachs's derivatives transactions are in principle under the SEC jurisdiction, but since Goldman Sachs does not keep them inside the broker/dealer division, its derivatives transactions are not filed with the SEC. They might even be under a foreign jurisdiction (e.g. the FSA jurisdiction in London) if Goldman Sachs executes them as a stand-alone bank in another country. The same applies to contracts for difference and repurchase agreements, which are covered by the SEC but only if the broker/dealer chooses to conduct its activity in the US. If it conducts it outside the US, it escapes SEC oversight. Furthermore, the activities executed in different countries are not aggregated, that is, they are not added to the overall activity of Goldman Sachs. The SEC, in fact, has responsibility for brokerage but not consolidated oversight of it. 'There is not one regulator that has ultimate oversight of US investment banks. Supervisors in different countries talk to each other, but it is fair to say that one can exaggerate the importance of this' (Anonymous 7, interview 2003).

Even when operations are executed in the US, however, prime brokerage can equally remain outside SEC jurisdiction. There is no SEC oversight, for instance, if a prime broker like

Goldman Sachs or Morgan Stanley advises clients that hedge funds are a good type of investment. There is no SEC oversight either if Bear Stern, which is the third largest prime broker for the hedge fund industry, but also a provider of office rental services, entertains a landlord/tenant relationship with a hedge fund and, on top of it, provides this hedge fund with financial services. If all these activities are in a stand-alone operation, there is no broker/dealer relation and no SEC oversight of it (Anonymous 7, interview 2003).

These examples show that firms will always find ways to escape regulation, even if this means creating new rules or new exceptions to existing rules. In the case of derivative transactions, for instance, the SEC capital requirements make it very expensive to conduct these operations as a broker/dealer. As a result, US firms (and especially investment banks) have set up special purpose companies – that is, companies set up to elude SEC requirements – just for the purpose of conducting derivatives transactions. Sometimes, it is not even a question of escaping a rule: as innovation in financial instruments is continuous and proceeding at a rapid pace, it can happen that rules for a new type of instrument have not been formulated yet, so that banks have to re-interpret existing rules. At this point, the burden of proof passes on to regulators, who have to prove that the interpretation of the banks is not correct (Anonymous 7, interview 2003).

Contrary to investment banks, commercial banks (bank holding companies) are said to be better supervised and less able to escape FED oversight (Frankel, interview 2003). Their annual reports reveal that only a small proportion of the consolidated bank company exists outside the bank (while for an investment bank only a very small proportion of the consolidated bank is within the broker/dealer section). Despite that, their supervision is not straightforward. This mainly for two reasons of complexity: (1) complexity in banks' organisational structure, which sees conglomerates of 250,000 employees, like in the case of

[65] The Office of the Comptroller of the Currency (OCC) regulates and supervises national banks and supervises the federal branches and agencies of foreign banks. The FED instead supervises state

City Corp, facing a couple of residential examiners; and (2) increased complexity in banks' models and instruments.

Major financial institutions in the US hold a policy of residential examiners, also called 'relationship managers'. This means that FED officials, whose number varies with the size of the bank, have an office within the bank and establish an ongoing relationship with it.[66] These residential examiners theoretically have access to all the bank's information. This, however, does not automatically assure that they have a good grasp of what the bank is doing. First, the information residential examiners collect cannot be shared outside the supervisory community. Even within the supervisory body, officials that are not involved in the supervision process are unaware of the results of the examination (Anonymous 14, interview 2003). The lesson from LTCM is to share more of this information, but this has not come about. It is justifiable that the examination takes place behind closed doors. After all, it is a matter of proprietary and private information. However, the extent to which this close-door practice is acceptable is open to discussion. Second, there are concerns that by being inside the bank the residential examiner can become more an 'advocate for' – as opposed to a 'supervisor of' – the bank. Third, there is a disparity of resources between regulators/supervisors and regulated/supervised. Taking the case of City Corp, the FED has full responsibilities over this bank, but it might have difficulties in understanding what the bank is doing because of the company's size: there are 250,000 employees in the face of few residential examiners (Frankel, interview 2003).

The second issue of complexity is the increased sophistication in the models used by banks and the speed of innovation in financial instruments. Most of the interviewed supervisors voiced this concern. As one of them said, 'the main concern for supervisors is with the

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member banks and international banks that have an office in the US.

[66] The FED adopted this practice 5 years ago, after the LTCM debacle. The Office of the Controller of the Currency, which supervises national banks, used to have residential examiners even before LTCM.

complex structures that banks build today, which is very different from only a decade ago' (Siddique, interview 2003; see also Anonymous 14, interviews 2002 and 2003; Frankel, interview 2003; Freeland, interview 2003). Supervisors in particular worry that these complex structures can hide the risk banks are taking, so that banks are not fully covered. In addition, supervising banks on the basis of models that they themselves elaborate encourages a form of 'smart escape' from regulation. Banks' managers know that, when regulators ask for a review of VAR policy, it is easy to make numbers appear in accordance with regulators' wishes, although, in reality, nothing has changed.[67] It is true, as (Anonymous 15) says, that 'banks have to prove to supervisors that their models make sense and supervisors need to be happy with it' (Anonymous 15, interview 2003). It is clear, however, that in this area banks retain a position of power in the balance of expertise.

This difficulty of monitoring the activities of banks explains why regulators are more inclined to delegate to banks and counterparties in general most of the work of monitoring and controlling HLIs. *But are banks willing to do so*? Is the assumption that banks and regulators share the same agenda tenable? Two developments in particular question the assumption that it is in banks' self-interest to perform due diligence in their dealing with hedge funds in the post-LTCM scenario. First, hedge funds are back into the banking market 'with lots of cross-over' (Anonymous 15, interview 2003). Second, the expectation that lending to hedge funds would drop after LTCM proved wrong.

Chapter 3 showed that banks have scaled down their proprietary trading operations after the heavy losses they suffered during the 1998 emerging market turmoil. It was shown, however, that this does not mean that banks quit this business, but only that they relocated it outside the reach of regulators. The drop in proprietary trading desks, in fact, has been paralleled by an equivalent increase in the number of hedge funds: these two events have to

[67] This conclusion draws upon several discussions with risk managers. However, the author assumes full responsibility for this statement.

be put in relation (Chapter 3). The relationship that banks entertain with their 'satellite' hedge funds has remained very tight (Chapter 3: 162-163). This – regulators in Basel think – means that banks are better able to supervise hedge funds' risk management systems (FSF 2001: 1). It might also mean, however, that bank stakes in the profitability of hedge funds and the competition around them is growing and, as a consequence, prudential management is being forgotten.

This is particularly the case with banks' provision of prime brokerage services. Banks have realised that they make more money with the margins they gain from this kind of operation than by playing the market themselves. As an IMF paper writes with reference to the currency market, 'the wealth of the commercial bank is a function of the number of contracts that the commercial bank can unwind through outright forwards and the number of contracts it has to unwind via spot and swap combination' (Lall 1997: 21). This means that by acting as prime brokers banks are going to cash in the fees no matter what will happen to the currency or the equity market, so that their operations are even more profitable than that of hedge funds – and this without taking open positions (ibid: 27).

Prime brokerage services for the hedge fund industry have substantially increased since 1998: Goldman Sachs has seen its net interest revenues increasing by 46 per cent over 1999 and Morgan Stanley by 20 percent over 1997 (Chapter 3: 157-158). Chapter 3 also showed that banks have started competing over the slice of the hedge fund industry they serve as prime brokers (Chapter 3: 156). With increased competition, margins from prime brokerage are getting slimmer (FSF 2002: 4). Banks, therefore, have an interest in hedge funds trading more aggressively rather than more prudentially, as the FSF requires. Chapter 2 reported that in the aftermath of September 11 banks and securities houses were called on not to lend securities to hedge funds in order to prevent them from selling those securities short. Calls of this kind might be vain if banks are the first to be interested in the short selling business with hedge funds. More generally, the FSF's reliance upon banks and other credit providers

to control hedge funds' leverage and risk might be misplaced if banks are the first to profit from high levels of leverage and aggressive trading.

This section has challenged two assumptions underpinning the idea of regulating hedge funds through counterparties: (a) the assumption that counterparties are adequately regulated and supervised in relation to their business with HLIs; and (b) the assumption that counterparties and regulators share the same agenda. These two assumptions proved largely untenable, which means that assuring systemic stability by relying upon banks is not straightforward.

Regulators do not have a great grasp of the activities of banks, and incentives exist for banks to join rather than 'fight' hedge funds. In order to work, indirect regulation through banks needs a powerful system of supervision and a strong system of incentives for banks to exercise due diligence. If, as the analysis in this chapter has shown, both these systems are weak, efforts to make indirect regulation work are bound to fail. However, even conceding that something can be done by indirect regulation, this only addresses the issue of systemic instability. The Financial Stability Forum, however, sets itself another objective, that of understanding the impact of hedge funds on market dynamics and integrity in small open economies. What happened to this second objective?

5.5 Second pillar: hedge funds do not have to be regulated at all

If hedge funds were best to be indirectly regulated for their role in LTCM-type of crises, they were not even considered in need of regulation for the role they played in the Asian financial crises: the two recommendations that concern the second pillar in fact do not tackle hedge funds. Three arguments were advanced to justify this decision: (1) lack of, or weak evidence on, hedge fund involvement in the Asian financial crises in 1997; (2) the unfeasibility of any regulation of hedge funds; and (3) the determinant role that weak

macroeconomic fundamentals played in the crisis-affected countries. As in the previous section, these assumptions will be assessed against the empirical evidence. The analysis will reveal that the rationale for not regulating hedge funds was motivated more by political than technical reasons – or rather the technical reasons of unfeasibility were clearly political.

As we have seen, the second pillar was concerned with the power of hedge funds to precipitate currency and equity market crises by taking large and concentrated positions (issue of market dynamics) and by using aggressive trading strategies (issue of market integrity). Attention focused on the case of small and medium-sized open economies and in particular on a group of 6 such economies where hedge funds were active in 1998: Australia, Hong Kong, Malaysia, New Zealand, Singapore and South Africa. An *ad hoc* study group was set up, the *Market Dynamics Study Group*, which has to be conceived as an FSF task force on currency crises. FSF regulators considered the conclusions of the Study Group as the highest-quality part of the FSF Working Group on HLIs. Despite that, they did not lead to any policy solutions to address the role of hedge funds in disrupting market dynamics and integrity. The conclusions were incorporated in the main FSF report (FSF 2000).

The FSF report begins with a series of important acknowledgments (e.g. the acknowledgement that hedge funds played a role in the currency devaluations in Asia). Yet it immediately dismisses their 'scientific validity' or the feasibility of the regulatory solutions they would lead to. As a consequence, the FSF report minimised the role of hedge funds and no major policy recommendation was included. As section 5.3 showed, only two recommendations concern the second pillar and none of them tackles hedge funds. The reminder of the section will look at various examples of this 'double approach': on the one hand the recognition of the problem and on the other the rejection of its significance.

To begin with, the FSF acknowledges the role of banks' proprietary trading desks. The FSF report writes: '[P]roprietary trading desks appear to have taken positions similar to those of many macro hedge funds and frequently used the same leveraged financial instruments' (FSF 2000: 111). The fact that banks also function as credit providers and prime brokers – and the conflicts of interests that can originate from these multiple roles – was also acknowledged:

> The proprietary trading desks are part of financial firms that execute and finance many transactions for major hedge funds. Thus, observers noted a structural opportunity for information on positioning by the major hedge funds to flow to the proprietary trading desks [...]. Such a structural opportunity could well be more important than any explicit collusion, of which the study group heard several reports (FSF 2000: 119).

Second, the FSF report accepts that HLIs played a role in precipitating currency devaluations because of the sheer size of their short positions. It writes: 'Short positions in the Hong Kong dollar, Australian dollar, New Zealand dollar, South African rand, Malaysian ringgit and Singaporean might have amounted at times during 1998 to as much as two to six months of exports' (ibid: 119).[68] The report also recognises that aggressive trading strategies were used to move market prices. Among these strategies, the 'talking the book' and 'spoofing' strategies are mentioned. The former means taking short positions in a currency and then making negative comments about it that will make its value collapse. Spoofing of the electronic broking services instead serves to make up movements in the exchange rate (FSF 2000: 131). In the analysis of Malaysia and Singapore, the report also acknowledges that exchange controls and restrictions on domestic funding by local authorities contributed to bring the strong speculative pressures to an end (FSF 2000: 133; 138).

Despite this thorough and open analysis, however, the conclusions on the responsibilities of HLIs in the emerging market turmoil of 1998 suddenly become sceptical and hesitant. The

[68] Battelino said that in the case of Thailand hedge funds' short positions were larger than the country's current account deficit (Battelino, interview 2003).

working group stated that no clear proof could be drawn from the analysis. Countries were affected by HLIs' large and concentrated positions and by their aggressive strategies, but other factors, such as vulnerabilities in the countries' macroeconomic conditions, heavily contributed to the crisis. More specifically, the FSF working group concluded that, though HLIs might have exacerbated the macro-economic situation during the Asian crisis and in the immediate aftermath, there was no sufficient evidence of their culpability and that, 'provided the economic fundamentals are strong, HLI positions and strategies are unlikely to present a threat to stability' (FSF 2000: 19). As for the issue of aggressive trading, though some practices were seen to constitute market manipulation, 'the working group as a whole was not [...] able to reach a firm conclusion on the scale of these practices and the implications for market integrity' (ibid).

After reaffirming that the most effective defence from speculative pressure is strong fundamentals (the classical efficiency justification), the report nevertheless makes a series of recommendations to prevent market actors from disrupting market integrity and market dynamics. These recommendations, however, are once again dismissed as unfeasible and it is clear from the text that they will not be pursued further. Usually, recommendations are followed by a series of 'buts' that explain why their implementation is unfeasible. 'Buts' are usually in italics and in bold characters.

This was the case with the recommendation to strengthen counterparty risk management, which is dismissed because 'even with reduced overall leverage, HLIs could still build large foreign exchange positions relative to these markets' (FSF 2000: 38-39). It was the case with the recommendation to strengthen risk management in the HLI sector, which is considered ineffective given that HLIs can 'build up potentially destabilising positions in small markets while remaining inside internal limits on leverage and/or liquidity risk' (ibid: 39). It was also the case with the recommendation to enhance aggregate disclosure on positions in key markets such as foreign exchange markets. This proposal, which was

brought forward by the French representative Jean-Pierre Patat and previously considered by the Committee on the Global Financial System, was one of the most contested issues in the whole debate. The proposal did not proceed further because it was felt there were several limitations, 'including the difficulty in obtaining compliance, the feasibility of producing the data in a timely manner, and the substantial costs involved' (FSF 2000: 40). Yet, several FSF members argued that the proposal was 'politically and technically doable' (Anonymous 1, interview 2003; see also Anonymous 11, interview 2003, Anonymous 10, interview 2003; Anonymous 2, interview 2003) and that 'despite some difficulties, it could have been implemented, given the current state of technological advance' (Anonymous 10, interview 2003). The proposal was instead abandoned 'without even verifying the claims of the private sector' (Anonymous 10, interview 2003).[69]

Finally, it was the case with the recommendation to enhance market infrastructure by requiring market participants 'to report to market authorities or disclose publicly short or long positions which exceed specified thresholds' (FSF 2000: 39). These disclosures would potentially prevent players from taking large and concentrated positions and/or engaging in aggressive strategies, since other players would be aware of the positions that they need to close. The Working Group, *however*, 'drew attention to the limitations of these measures', particularly the fact that only activities on organised exchanges would be monitored thus leaving out the OTC markets.

The reason justifying the refusal of any direct regulation of hedge funds for the purpose of enhancing market integrity is particularly interesting. The following quote is probably the clearest statement that banks are not more regulated than hedge funds are and that, as things

[69] The industry was adamantly against it for two main reasons: (1) as the largest players in these markets are few, it is easy for the market to spot those who have open positions and trade against them; and (2) data would have been incorrect and approximate. These reasons have never been verified.

stand right now, strengthening the existing banking supervision will not make much difference in terms of protecting countries from speculative strategies:

> The Working Group noted that the concerns expressed by small and medium-sized open economies has been generated as much by entities which are currently subject to existing prudential regulatory regimes, as those by unregulated funds. Although these regimes include measures such as large exposure limits, such limits would rarely act as a constraint on the foreign exchange position taking of large banks in small and medium-sized open economies. The Working Group therefore considers that this form of regulation or supervision would do little to address concerns about market dynamics in small and medium-sized open economies (FSF 2000: 42).

In the end, only two recommendations were included in the final list of 10 FSF policy options (reported in section 5.2): (a) enhancing national market surveillance and (b) formulating good practice guidelines for foreign exchange trading. The first recommendation calls on national monetary authorities to entertain a dialogue with market participants (large foreign commercial banks as well as local banks), so as to collect information on speculative activities in their own markets. Surveillance should be limited to this kind of *informal dialogue* and position monitoring, while the Working Group remains sceptical about more 'formal limits' (FSF 2000: 41), such as the capital controls introduced by Singapore and Malaysia. The second recommendation calls on market participants to prepare 'good practice guidelines' for foreign exchange trading. It calls participants in advanced financial markets 'to draft a set of guidelines of good trading practices that might usefully serve as a model for foreign exchange trading communities in small and medium-sized open economies' (ibid: 42). Seen as an alternative to direct regulation (ibid), these codes and guidelines will not be legally binding and their implementation will rest upon the good will of market participants.

After its main report in April 2000, the FSF Working Group carried out two evaluative exercises in 2001 and 2002. What emerged from both reports was that the only concrete result in terms of implementation was the drafting of guidelines for good trading practices in foreign exchange markets. In the 2001 updating notes, the FSF declared itself to be satisfied

with the drafting of 'Trading Principles' by a group of 16 major (Western) commercial and investment banks. Nothing else is mentioned in the report. In the 2002 updating notes it was mentioned that 'concerns continue to be expressed by some about short selling', particularly with reference to the allegations of massive short selling by hedge funds in the aftermath of September 11 and in the Japanese stock market in the Spring of 2002 (International Securities Finance 2002: 10).[70] *However* – the report concludes, these allegations 'have not been verified' (FSF 2002: 8). In another note it is also insinuated that the reason not to pursue the second pillar (market dynamics and integrity) further is that 'there have been no recent confirmed reports of instances in which HLIs have been at the centre of aggressive trading strategies or have taken concentrated positions of a scale that have threatened the orderly functioning of markets' (ibid: 12).

In other words, regulators said that the reasons not to pursue further the second pillar of the FSF mandate had to do with (1) lack of reports/cases of market disruption since 1998 and (2) lack of evidence against short selling in recent market episodes. Hedge funds, however, were involved in at least one major instance of aggressive trading: the building up of the Internet bubble, where their role was as central as those of banks (Chapter 3). Even without considering the aftermath of September 11 (Chapter 1), there have been at least two other major instances of short selling (whether operated by hedge funds or other players) disrupting market integrity: (1) the attack to the Japanese stock market in the Spring of 2002; and (2) a continuous instance of disruption in the 34 months of negative market valuations that followed the Internet bubble (March 2000). This is not to mention the many cases of individual attacks on companies, which were not always justified by their distressed situation or poor fundamentals.

[70] The Japanese stock market became the target of short sellers in March 2002. As a consequence, regulators in Japan introduced some limitations to the practice of short selling.

The argument about the lack of empirical evidence against the practice of short selling is even more untenable. As a matter of fact, evidence on short selling (either in favour or against it) is missing. Short selling in fact is not subject to any reporting requirement. In the UK, 'information on short selling is not collected' (FSA 2002d: 3), neither through the London Stock Exchange nor in any other way. In the US, what is disclosed is the aggregate figure of the short and long positions in each stock traded in the cash equity markets, but this leaves out those short sales carried out through contracts for difference and derivatives (which are likely to be the bulk of it). The situation does not improve in the currency market, where no data on either short or long positions taken by market participants is available. As the French authorities rightly pointed out, 'in its 2002 review the FSF concluded that there has not been any indication of problems linked to short selling. But if there is no data, how is it possible to know if there is a problem in the first place?' (Visnovsky, interview 2003)

In reality, the second pillar is not pursued further because to do so would require addressing the very mechanism of financial speculation and inequalities/distortions in the allocation of resources (see next section). The way regulators have conducted their defence of short selling shows how much they see it as a defence of the very essence of the neo-liberal market system. Howard Davies, Chairman of the Financial Services Authority (FSA), shows at best scepticism about any attempt to regulate short selling, a practice – he says – that

> 'is a normal activity, which, indeed, has some pluses associated with it in terms of speeding the necessary process of price adjustment. There are those, notably in Japan and Germany who want to control short-selling directly. Good luck to them. But a financial centre like London which prides itself on its openness and flexibility should think long and hard before imposing such restrictions. [...] I hope that at the FSA we can hold the line and not be pushed into more restrictive measures [...]' (FSA 2002c).

The immediate reference is to the cases of Germany and Japan, which have recently introduced some limitations to the practice of short selling in their domestic markets. A more implicit reference is to the cases of Singapore, Malaysia and Hong Kong, which in

different ways and times introduced restrictions to the use of short selling. Restrictions to the lending of stocks and currencies to non-residents were in fact another way by which the above-mentioned countries implemented *capital controls*.

In a concluding note, one might wonder why, if all the recommendations taken into account had so many limitations, other suggestions were not considered. The next section will try to answer this question by calling attention to the lack of alternative 'frameworks' in which one can think about financial regulatory solutions. It is clear, however, that the lack of alternative frameworks complemented the lack of political will to take the discussion on the second pillar further (Chapter 4). Issues of market dynamics were not the main concerns of developed countries – especially the US – and, furthermore, any regulation involving the use of capital controls would have hindered the activities of the transnational financial community.

How did emerging markets take the 'consensus' decision not to regulate hedge funds? FSF officials report that soon after 1997 and 1998 emerging markets were very upset at the outcome of the debate in Basel, but that afterwards very few complaints were made. According to Kostas Tsatsaronis, the reason was that 'the big macro funds went out of fashion and the other hedge funds got interested in securities markets in industrial developed countries' (Tsatsaronis, interview 2003). Since hedge funds do not have the capacity to trigger market disruption in advanced markets, the problem of market dynamics/integrity was no longer felt as such.

The view that emerging markets are no longer hedge funds' favourite places, however, is controversial. Other sources, such as *The Financial Times* correspondent Robert Clow, argue that in 2002 money started flowing again into emerging markets and that hedge funds are back to macroeconomic bets. Once again global macro funds have started generating returns through the dollar/euro and dollar/yen strategy (selling short yen and buying long

dollar or the other way around). So there is (or it can be expected to emerge) a new generation of global macro managers trading on emerging market results' (Clow, interview 2002). If this proves correct, macroeconomic bets will strike again, whereas in the meantime not much has been done in terms of regulation compared to the pre-1997 situation (Anonymous 10, interview 2003).

5.6 What regulators do not ask

It is clear from the previous two sections that the questions raised at the regulatory table in Basel are only a limited and partial set of possible questions, particularly for what concerns issues of market dynamics and integrity and the practice of short selling. Disruption of market dynamics and integrity comes in different forms and can (and should) also be read in terms of distributive effects and inequalities of market outcomes. This section does this by looking at the privileged treatment of short selling in relation to other market practices. It also shows how antagonisms in finance are hidden within the most technical issues of investment and trade.

Altogether regulators put forward three questions with regard to the issue of market dynamics and integrity. The first two – whether there is any evidence of the negative impact of short selling on market dynamics and integrity and whether there has been any instance of market disruption after the events of 1998 – were analysed in the previous section. The third question, which is analysed in this section, asked why short selling should be considered more harmful and market destabilising than buying long.

Short selling is generally referred to as 'a valid investment practice that [...] represents the opposite of taking a long position' (FSA 2002d: 18); in other words, the selling side as opposed to the buying side of financial markets. Those reluctant to tackle short selling begin by asking 'why should short selling be considered more harmful and market destabilising

than buying long? We have all seen what happened with the Internet bubble: people kept buying and prices went up to such an extent that it generated the biggest bubble in the financial history'. This offers an image of financial markets as perfectly symmetrical machines where the selling side is counterbalanced by a buying side, separate and opposite to it. There are at least three reasons why this might not be the case. Firstly, short selling is often to be read in conjunction with the buying side. There is obviously a link between those who pushed Internet valuations high and those who started shorting Internet stocks. Secondly, short sellers are not single individuals that just happen to be short. Short selling is an activity carried out by the most informed, sophisticated and financially educated elite within the market: selling short is not like selling *tout court* or buying long to keep. Short selling – especially when carried out through single-stock futures and put options – is – statistics at hand this time – circumscribed to hedge funds, prime brokers, and banks. Supporting free and unscathed short selling is like supporting a systematic redistribution of wealth from ordinary investors/depositors to the 'pros' (i.e. sophisticated investors). Thirdly, there is a clear inequality in the treatment of short and long positions for disclosure requirements. Short positions do not have to be disclosed as much as long ones have to. Starting from this latter point, the remainder of the section will show an example of unequal treatment of investment practices and thus of different classes of investors.

The disparity of disclosure requirements between those on the buying side and those on the short selling side is striking. If an investor in the UK buys more than a certain percentage of the shares of a company – precisely, more than 3 per cent (Companies Act 1985, see FSA 2002d: 25) – they are required to report it. If, in the same situation, another investor or trader sells short 3 per cent of the same shares, they are not required to report it at all. The same happens when these transactions are carried out through put options, which are the economic equivalent of short selling. Put options are not subject to any disclosure requirement, while call options (the buying side) are. The FSA in London claims it found a way to monitor short selling by placing the disclosure requirement upon the prime

broker/bank that is lending the stocks necessary to do short selling (again a case of *indirect* regulation). In order to lend the shares, the prime broker has to borrow them first: if the borrowing substantiates a position higher than 3 percent, this triggers the reporting requirement, as in the case of buying (Companies Act 1985, see FSA 2002d: 25; Anonymous 12, interview 2002). Market players, however, have found their way around this requirement. Here comes the smart game. While it is true that one has to report any borrowing above the 3 percent threshold, nobody forbids borrowing stocks from different owners. So, for instance, by borrowing 3 quotas of stocks of less than 3 percent each, no reporting requirement is triggered (Anonymous 12, interview 2002).

The same happens in the US market. In the US, however, short positions are slightly more transparent: the aggregate short position in a share is publicly reported (see for instance the long/short column in the *Wall Street Journal*, also called *short interest*). This, however, only gives the aggregate data on short positions in the *cash* equity market and leaves out OTC markets, repurchase agreements and contracts for difference (see above), which constitute the bulk of the short positions in a share.

As for its re-distributive effects, short selling can contribute to the polarisation of income and wealth. Let's suppose that a bank (or a mutual fund) owns both a hedge fund and a pension fund under the same company umbrella. Pension funds collect money from the broad public, while hedge funds traditionally collect money from high-net-worth individuals and institutions. Let's then suppose that the pension fund arm is buying a certain quantity of shares of the company X. The hedge fund arm is instead shorting the shares of the same company X. The pension fund has to declare its investment in stock X, while the hedge fund does not have to disclose its intention to sell short X. If the hedge fund's positions are large and concentrated enough to cause the stock prices to fall, this means additional profits for the hedge fund and losses for the pension fund. Though the management of the pension fund and the hedge fund should be kept completely separate, it is obvious that the parent

company has an interest in privileging the hedge fund operation. Fees in pension funds are much lower than in hedge funds: a few percentage points in the former against up to 20 percent in the latter. This means that profits accruing to the hedge fund are more valuable that profits accruing to the pension fund. Hence, the parent company might be willing to privilege the former over the latter. In so doing, the parent company materialises a transfer of money from the pension fund's clients (ordinary investors) to the hedge fund's clients (high-net-worth individuals). The manager telling this story concluded by saying: 'if there is one instance like that, it means that there are many more others, as markets are homogeneous' (Anonymous 12, interview 2002). More research on similar cases and on the distributive impact of market practices is warranted.

Yet whenever those 'alternative concerns' about short selling are brought to the attention of regulators and financial players, they display a genuine disbelief. Faced with the question 'what about the impact of short selling on wealth and income level and distribution?', three prominent regulators in Basel answered in the same way: 'it is an interesting point, but I have never thought about it' (Crockett, interview 2003, Andresen, interview 2003, Tsatsaronis, interview 2003). This is exactly the point: beyond the US dominance in any forum discussing financial market reforms, the basic truth is that there are no tools to propose alternative solutions to the current regulatory setting. Alternative solutions should not be thought of in terms of 'alternatives to the market system', but more simply to the policy proposals brought forward in circles like the Financial Stability Forum or the Basel Committee.

5.7 Conclusion and policy options

This chapter has complemented the analysis of power that began in Chapter 4 by introducing the role of the structure of meaning or discourse surrounding the regulatory debate on hedge funds. Section 5.2 has outlined the main elements of this structure:

efficiency, financial stability, equilibrium, due diligence and an individualistic understanding of risk. Sections 5.3 through 5.6 have analysed how these elements have influenced the decision-making process in Basel. Section 5.3 has analysed the decision to privilege the first pillar (systemic stability) over the second one (market dynamics and integrity). Section 5.4 has analysed the decision to indirectly regulate hedge funds to address the systemic stability concerns triggered by hedge funds. Section 5.5 has looked at the decision not to regulate hedge funds at all for issues of market dynamics and integrity. Section 5.6 has analysed what has remained unsaid in the debate on hedge funds and has particularly emphasised the lacuna on issues of equity and accountability. This last section has prepared the ground for the discussion in Chapter 6, which deals with other 'unsaids' in the regulation of hedge funds. Before moving to Chapter 6, a few concluding remarks will be made on the policy solutions that stem from the *regulation-as-discourse* explanation provided in this chapter.

The policy solutions that arise from such an explanation of the hedge fund debate are more ambitious than the ones outlined in the previous chapter. They advocate a rethinking of the structure of meaning within which discussions of global financial governance take place and, more specifically, of the criteria and principles that underpin the current regulatory philosophy at both the international and the domestic level. According to this perspective, before calling for a larger inclusion of developing countries and stakeholder groups into the FSF, it is crucial to understand what financial stability, efficiency, due diligence, risk and regulation means within a particular regulatory framework. The risk is that, without doing this, the current regulatory structure and philosophy will become 'even more firmly constrained within the accepted criteria of a specific social form' (Edkins 1999: 11) and are unlikely to be revised and re-discussed later on.

A rethinking of this regulatory structure of meaning could start by challenging our current financial knowledge – e.g. the very assumptions and ideas that inform both the theory and

practice of finance. A few steps in this direction can be attributed to the proliferation of initiatives to counterbalance the overarching influence of mainstream finance. The thesis has drawn on the contributions of the *Association for Heterodox Economics*, the *Post-Autistic Economics* movement and the *Alternative Perspectives on Finance and Accounting Journal.* This is clearly not enough. All these contributions in fact originate from Economics and rarely from other disciplines. More research on the *politics* of financial regulation should be carried out and funded outside Business Schools and Finance Departments.

Finally, the point to be made here is that the analysis of the structure of meaning or discourse should not be seen as a stand-alone operation. It is clear that this discourse promoted a particular set of interests, which are those of the most sophisticated and global segment of the financial community (global investment and commercial banks, hedge funds, large institutional investors such as mutual funds and insurance companies). This is the same set of interests that were portrayed as dominant in Chapter 4. Strategies of power and systems of thought, in other words, should be seen as mutually interrelated and self-reinforcing. A clear example comes from the frequent argument that 'emerging countries were not able to make a strong case on the regulation of hedge funds' (Anonymous 3, interview 2003). Regulators in Basel have seen this as further confirmation of the lack of empirical evidence against hedge funds (first explanatory model). It can also be seen as the result of the relative power of actors at the FSF regulatory table, where the US authorities dominated the agenda (second explanatory model). Or it can be seen as the proof of the difficulty of advancing alternatives to market discipline (third explanatory model). The structure of meaning in finance is incredibly convincing in refuting all options that do not remain within the logic of unscathed free markets – with the practice being even more orthodox than the theory.

This structure of meaning is also crucial to understand the investigation carried out in the next chapter. Chapter 5 in fact should be read in conjunction with Chapter 4 but also with

Chapter 6. The three chapters analyse from different angles the role of regulation in fostering financial speculation. Chapter 6 will analyse regulatory initiatives that are apparently unrelated to the debate on hedge funds. It particularly looks into some regulatory initiatives that have increasingly promoted a hedge fund mode of investing. It will argue that the hedge fund mode of trading has been blessed twice: by leaving hedge funds substantially unregulated and by promoting initiatives that will foster their presence in the market.

CHAPTER 6

THIRD EXPLANATORY MODEL:

What the Regulatory Discourse Does Not Say

6.1 Introduction

Chapter 5 showed how the structure of meaning within which discussions of hedge funds took place influenced regulatory decisions at the Financial Stability Forum. This structure was said to provide limitations to the kind of problems that could be discussed and to the solutions that could be advanced. It was named a 'regulation-as-discourse' approach to the study of regulatory decision-making processes. According to this approach, by looking at the way problems are framed and questions are raised in the debate on hedge funds, it is possible to explain why certain issues made it to the regulatory agenda while others failed to be considered.

This chapter explores other ways in which Foucault's concept of the 'unsaid' could be employed. Chapter 5 defined the unsaid as what fails to be accounted for or be acknowledged as a problem in a particular discourse (Chapters 1 and 5). Chapter 5 provided several examples of the unsaid. For instance, it showed how the impact of short selling in general and its role in the market downturn following the Internet bubble in particular were dismissed as irrelevant or not even conceived as problems. This chapter expands the sectoral scope of the analysis by including regulatory developments in other industries that impact upon the regulation of hedge funds. It argues that, while addressing hedge funds with an *ad hoc* forum (FSF) at the international level, in other contexts the very techniques that hedge funds use have been promoted and legitimised. This complements the analysis in the previous chapter and provides a further illustration of how hedge funds have been 'blessed' instead of being tamed. The chapter considers two cases of this 'authoritative blessing': (1)

recent US legislation on derivatives and specifically some consequences of the Commodity Futures Modernization Act of 2000; and (2) developments in the US and UK mutual fund industries.

Before starting the analysis, it is necessary to justify this choice of case studies. More generally, which methodology should be used to 're-consider' the unsaid? How is it possible to make links, to connect issues that are apparently unrelated, and to discern, among the multiple rules and regulations that govern financial markets, those that constitute the unsaid? The thesis argues that this 're-consideration' and 're-inclusion' of that which is missing within a dominant discourse is a core component of a post-structuralist methodology. One excellent example is provided by Shapiro's work on public policy. The methodology he uses to *defamiliarise* the questions that policy-makers raise around traditional policy concerns helps uncover other questions, which the policy-makers fail to ask (see Chapter 1: 65).

However, while the principles underpinning this methodological perspective are easy to explain, the choice of the specific empirical studies cannot be explained according to any pre-constituted criteria. Recent changes in the US legislation on derivatives as well as developments in the mutual fund industry provided excellent examples of how a hedge fund mode of investing has been promoted in other industries too. They are not, however, the only examples that can be made. In principle, there can be a multiplicity of unsaid situations and further research is warranted to find out those other instruments or industries that are becoming – or are helped to become – more oriented to a hedge fund mode of investment.

Section 6.2 analyses the mutual fund industry and precisely: (1) how the Securities and Exchange Commission (SEC) has interpreted the dictum of the Investment Company and Securities laws in an increasingly relaxed way, so that registered companies (e.g. mutual and pension funds and insurance companies) are now able to avoid many of the restrictions that

forbade them to act as hedge funds (segregated requirements, restrictions on senior securities, etc.); (2) how changes in the US Tax Code produced a similar effect by granting mutual funds more room to use short selling; (3) how mutual funds, pension funds and insurance companies have increasingly participated in the hedge fund industry by acquiring or investing in hedge funds.

Section 6.3 instead considers the consequences of the Commodity Future Modernisation Act (CFMA) on both the US and world markets. Two aspects will be analysed in detail: (1) the re-introduction of single-stock futures (SSFs) and the opportunities that SSFs offer to sell short; and (2) the ambiguous nature of the CFMA legislation, which is at the crossroads between regulation and deregulation.

6.2 Hedge funds in the mutual fund industry

Chapter 3 showed the increasing difficulty of defining hedge funds in opposition to mutual funds and other traditional asset classes. Many features of the hedge fund mode of investing, it was said, are now part of the strategies of banks, mutual funds, pension funds and insurance companies. This chapter explores a further issue: domestic regulation in the US and the UK has facilitated convergence in investment strategies by relaxing many of the restrictions that impeded traditional asset managers from using short sales and leverage. Unlike the rest of the thesis, this section analyses developments in both the US and the UK market.

This section begins by analysing what has changed in the traditional investment industry and why hedge fund practices are taking over in this sector. Mutual and pension funds (and partly insurance companies) are jointly considered, insofar as they are regulated by the same investment company acts and, in principle, have to conform to the same investment

regime.[71] The rationale behind this regime is the same as that which underpins the regulation of banks: mutual funds, pension funds and insurance companies collect money from small depositors and investors, whom regulators deem worthy of protection.

Chapter 2 explained that hedge funds exist because of a loophole in the US Investment Company and Securities regulation implemented in the Post-Depression years. It also explained how the reasons for hedge funds being unregulated are the same that impose regulation upon mutual funds. Mutual funds are restricted in their ability to use short selling and to buy securities on margin as these are considered to be leverage-enhancing instruments to be limited in the case of mass investment schemes (while they are not restricted in the case of hedge funds, whose investors are high-net-worth individuals and large institutions).

The same rationale lies behind another provision under section § 18 (f) of the 1940 Act, which prevents mutual funds (and registered investment companies in general) from issuing so-called *senior securities*. Senior security was defined as including 'any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness' (§ 18 (g) of the 1940 Act). The prohibition to issue senior securities was designed to prevent mutual funds from issuing instruments and engaging in transactions that were likely to create leverage. The restriction could be overcome by putting aside a 300 per cent asset coverage with a bank (section 18(f)). Alternatively, 'to avoid the creation of a senior security and thus to avoid a violation of Section 18(f), a Fund may establish a segregated account to limit the amount of potential leverage inherent in the Senior Securities Transactions' (SEC 1996 No-Action LEXIS 634: 2).

[71] In the US, they are regulated by the Investment Company Act of 1940.

The SEC, however, in several successive no-action letters[72] published between 1987 and 1999, has made it easier for funds to broadly interpret the dictum of Section 18(f) and avoid the more onerous segregated account requirements. In a reply to Merrill Lynch Investment Management (which is Merrill Lynch's mutual fund), the SEC affirms the principle that a segregated account does not imply that the fund has to take assets as 'physically' segregated. It is sufficient either a note from the custodian bank that says that these assets are segregated, or that the fund owns the securities that it has promised to deliver, or that segregated assets include assets that are deemed liquid by the Fund's Board of Directors[73] (SEC 1987 No-Action LEXIS 2179: 2).[74] In particular, in a no-action letter against Dreyfus Strategic Fund, the SEC affirms that 'a fund that engages in short sales, short positions, and sales of call options need not segregate fund assets if it "covers" these positions in the following ways: [(1)] a fund selling a security short may own that security or hold a call option on that security with a strike price no higher than the price at which the security was sold' (ibid); or (2) in the case of a short position in a futures or forward contract , the fund 'may cover by owning the instruments or currency underlying the contract or by holding a call option permitting the fund to purchase the same futures or forward contract at price no higher than the price at which the short position was established' (ibid: 2-3). In this way, the Securities and Exchange Commission accepts for mutual funds some of the risk management practices generally used by hedge funds. This means that a fund can use short selling if it takes offsetting positions, which is exactly what a long/short equities (or relative value) fund does (see Chapter 2).

Let us suppose that a mutual fund wants to sell a security short in the expectation of its price going down. According to the SEC interpretation of the law, it can sell it short if it takes an

[72] A no-action letter shows the intent of the SEC not to pursue any legal action against behaviour that is in principle against its rules and regulation. By so doing, the SEC sanctions that such behaviour is permissible in the future.

[73] This means any liquid equity securities and debt securities of any grade and not only high-grade debt securities.

offsetting position (e.g. it enters into a contract to buy the same or equivalent security long) so as to hedge the risk of that equity's price increasing instead of falling. This is exactly what a long/short hedge fund does and, for instance, what LTCM was doing. It is certainly expensive to take offsetting positions, and this is how the regulator hopes to discourage short sellers. However, with the use of derivatives (see following section) offsetting positions can be taken by only putting aside 10 per cent or less of the value of the position. The use of derivatives is not forbidden to mutual funds, contrary to what many practitioners and academics say (Temple, interview 2002;[75] David Friedland, interview 2001; Dion Friedland 2000). The SEC in fact concluded another no-action letter by saying that a mutual fund could meet its asset segregation requirements and take offsetting positions by using complex option strategies (SEC 1989 No-Action letter Hutton Options Trading L.P.; SEC 2002 No-Action letter ReFlow Fund LLC).

The fact that the SEC has relaxed its interpretation of the law for what concerns senior securities transactions is part of a broader cultural change in the interpretation of the role of short selling. It also displays a fundamental feature of the current regulatory regime: an exclusively *individualist* concept of risk. While the change in the understanding of short selling will be dealt with in section 6.3, this section discusses the individualist concept of risk as an application of what has already been said in Chapter 5.

In interpreting the legislation on mutual funds, the SEC says that mutual funds can sell short or enter into 'senior securities' transactions only if they hedge the risk of doing so, that is, if they protect themselves by taking offsetting positions. Apart from the fact that offsetting positions do not necessarily neutralise or reduce risk (see Chapter 3 for a discussion of the

[74] All no-action letters quoted in this section were obtained from the Securities and Exchange Commission (Rubenstein, interview 2002), documents available from the author.

[75] As Temple says, It is limited the amount that mutual funds can invest in limited partnerships or offshore funds and their use of derivatives. Some states in the US (e.g. the State of New York) do not allow pension funds to invest in hedge funds' (Temple, interview 2002). The discussion in this section shows how these rules can be partly circumvented.

unlikelihood of two offsetting positions to exist in the first place), the 'individualist' nature of this interpretation of risk is self-evident. All that matters is that market players are covered for the risk of their own insolvency. As Chapter 5 described at length, one of the tenets of the current global financial governance is that risk is conceived only as risk for the individual market player. The inevitable consequence of this interpretation is that most individuals are totally unprotected against events in financial markets, whether during a crisis or during normal times, simply because they are not 'market players'.

Apart from the changing interpretation of what mutual funds can do to increase their leverage, there have been two further developments in the industry: (1) taxation has become more short selling- and leverage-friendly; and, exactly like banks, (2) mutual funds have started acquiring or launching hedge funds. As for the first point, the reference is to the repeal of the 'short-short rule' in the US Internal Revenue Code (Title 26, Subtitle A, Chapter 1, Subchapter M, Part 1, Sec. 851). Before 1997, mutual funds had strict limits to the amount of profit they could earn from short-term trading strategies such as short selling (FSF 2001: 4). A rule called the 'short-short rule' or the '30 percent test' required that mutual funds derived less than 30 percent of their gross income from the sale of securities held for less than three months and from the use of short term strategies in general. If they wanted to qualify as Regulated Investment Companies (RIC), they had to abide by the short-short rule, among other conditions (Internal Revenue Code Sec. 851). Once qualified for RIC treatment, they could avoid corporate taxation. So the trade off was between a more liberal regime in the use of derivatives and leverage and a more accommodating tax regime. This ceased to be a trade-off in 1997, when the 106th Congress passed the 'Taxpayer Relief Act', which, among other things, repealed Section 851(b)(3) (the 'short-short rule'). One of the consequences of the repeal of this provision was that it allowed mutual funds to include derivatives and short selling in their trading strategies without them losing their tax exemption. As in the case of the no-action letters, this repeal was presented as an overdue

act, designed to get rid of obsolete provisions and help markets keep pace with continuous developments in the industry (CBOE 2002).

No equivalent legislative action was implemented in the UK, though some developments in this direction can be found in the Myners Report, which was submitted to the Chancellor of the Exchequer in March 2001 (Myners 2001). The Treasury commissioned the report to Paul Myners, chairman of Gartmore Investment Management, to provide a review of institutional investment in the UK. More precisely, the report was commissioned to review the causes of the perceived failure of the UK traditional investment industry (insurance companies, mutual and pension funds) to commit more substantial funds to private equity. Private equity is herein defined in very broad terms to include all investment in venture capital (e.g. start up companies) and in limited partnerships (e.g. hedge funds). In other words, private equity is what is not publicly traded. Regulatory as well as educational constraints were identified as major causes for the lack of investment in these asset classes. Both the government and the FSA pledged to provide incentives for traditional funds to invest in various sorts of private equity, including funds of funds and hedge funds (Myners 2001). 'The government said [...] that it would incorporate Mr Myners's recommended changes to the legislation under the Financial Services and Markets Act to change investment restrictions on pension funds to make it easier to invest in these limited partnerships' (Treanor 2000).

In brief, UK pension and mutual funds were accused of being too conservative and unnecessarily wary of derivatives and hedge funds. Initiatives were urged to stimulate pension funds' investment into hedge funds, among other strategies. 'The Myners Report urges the creation of a code of conduct for pension fund managers that would require managers to explain [...] why they have not invested in hedge funds or used derivatives to hedge certain risks' (Faille 2001; see also Myners 2001, Chapter 11, point 11.5: 147 and point 7: 149). Chapter 11 of the Myners Report, which summarises its main

recommendations, points out that: 'trustees should... whether they believe active management has the potential to achieve higher returns [...] giv[e] managers the freedom to pursue genuinely active strategies' (Myners 2001: 149). In this way, investment in private equity and limited partnerships becomes part of a set of best practices that mutual and pension funds are urged to follow. There is no need to explain that this will result in the 'normalisation' of what were previously perceived as speculative investment strategies (hedge funds). Paul Myners, the author of the report, is the chairman of Gartmore Investment Management, which practitioners (Ingram, interview 2001; Temple, interview 2002) frequently cite as an example of a mutual fund with large investments in hedge funds. Chapter 3 described various other cases of mutual funds that like Gartmore are increasingly exploring the new opportunities of investing in hedge funds.

The normalisation of hedge fund strategies will be operated both through regulatory and education change. It is a rule for mutual and pension funds to state their investment policy in their prospectus and to stick to the investment goal approved by their trustees and investment committees (Matthews, interview 2002). Trustees and investment committees thus play a fundamental role in deciding the policy that the fund is going to pursue. For these reasons, if mutual and pension funds want to expand into the hedge fund business they need to educate trustees, investors and stakeholders in the benefits of a hedge fund mode of investing. Educational efforts such as those promoted by major banks and mutual funds (including the Myners Report) have to be seen within the broader project to make short selling and hedge funds accepted as 'normal' market strategies. As Temple said, allocation will grow even faster once 'the trustees of pension funds and the public in general become accustomed to the idea that hedge funds do not represent a speculative, high-risk investment' (Temple, interview 2002).

6.3 Hedge funds and single-stock futures

Chapter 3 described the links between hedge funds and derivatives. First, it was said, hedge funds make substantial use of derivatives. Second, derivatives are the economic equivalent of hedge funds. In 2000, while the debate on hedge funds was carried out, both at the US Congress and at the Financial Stability Forum, the US House of Representatives passed a bill that was going to make easier, cheaper and in principle indiscriminate the use of short selling.

Chapter 3 identified and discussed the main derivative instruments. Put options and single-stock futures were particularly considered to be the economic equivalent of short selling. We have thus seen how put options are contracts giving the buyer the *option* to sell a certain amount of shares at a future date and at a fixed price, while single-stock futures are contracts by which one part *promises* future delivery of an asset to the buyer at a prearranged price. We also saw how, contrary to options, which require the payment of a fee, single-stock futures are virtually free and only require a deposit to cover potential losses (Jenkins 2000). Single-stock futures, therefore, are not only the economic equivalent of short selling, but a very cheap one.

Single-stock futures and options relate to the debate on the regulation of hedge funds in two ways. First, many commentators observed that regulating hedge funds would have been ineffective, as the same operations could have been carried out by using derivatives. Investors would have circumvented the restrictions on hedge funds and used derivatives instead. Second, hedge funds were said to be able to use derivatives much more freely than any other market actor because of the lack of reporting requirements and regulation upon them (e.g. the case of LTCM). However, while FSF and US regulators were debating these issues, another piece of legislation was introduced and eventually passed by the 106th US Congress in December 2000. The bill was named the Commodity Futures Modernisation Act of 2000 (CFMA 2000). Among other things, this legislation re-introduced single-stock

futures (SSFs) into the US market after a ban lasting almost 20 years. The importance of this event is to be measured not just in terms of the concrete consequences of single-stock futures, but also for its symbolic value: it is a further step in the normalisation of a hedge fund mode of investing.

Single-stock futures were banned in 1982 with what came to be known as the Shad-Johnson Accord. The ban was justified by a certain mistrust for short selling and especially the easiness with which short selling could be done by using SSFs (Ebersole, interview 2002):[76] with a minimal deposit, investors could potentially short a huge amount of stocks without actually holding them. There were also fears about the manipulative potential of SSFs, which were less regulated than stocks and other derivatives for issues of insider trading and manipulation laws. Mistrust of short selling also produced the up-tick rule in the US national exchanges: this rule, which was introduced in the post-Depression years, prevents traders from selling a stock when its price is falling. The result of the CFMA was to overcome these rules altogether, the Shad-Johnson agreement explicitly and the up-tick rule implicitly.

Before discussing the impact that the repeal of the ban will have on domestic and international markets, the main features of SSFs will be summarised. To begin with, single-stock futures allow to sell stocks short much more easily than by going to the cash market. Instead of having to borrow the stocks to sell short, it is enough to sell a SSF contract. Second, SSF provides a cheaper way to do short selling: as things stand in 2002, single-stock futures are subject to lower fees than stocks and stock options.[77] In the case of single-stock futures the trader only has to pay a margin, while in the case of options they have to pay the premium plus possibly a margin. As a paper of the Centre for the Study of Financial

[76] The other reason for the endurance of the ban was that the regulator in charge of securities (SEC) and the one in charge of futures (CFTC) could not find any agreement on how to split their respective responsibilities. This produced a regulatory stand-off.

Innovation (CSFI, London)[78] points out, 'a [single-stock] future appeals to the speculator looking for quick and cheap exposure' (Lascelles 2002: 14).[79] For this reason, according to CBOE Chairman William Brodsky, SSFs are going to lower the cost of trading on margins, which is what traders do to take leveraged positions (CBOE 2001). In addition, SSFs are going to lower the cost of trading on margins *for every trader*, not just for hedge funds, and by so doing will provide investors (in principle any investor) with an easy and cheap way to sell short. Third, stock futures can be sold short without abiding by the up-tick rule that instead exists in stock exchanges (cash market). As we shall see, this means that short selling can be carried out with virtually no restriction. The other side of the coin is that SSFs are riskier than options: while with an option the maximum amount one can risk is the cost of buying the call or put option, with single-stock futures margins can be called (e.g. increased) every day and losses can be potentially unlimited. Options can be said to provide for a sort of insurance, while futures only provide for market exposure (Lascelles 2002: 14). This means that single-stock futures are more likely to lead to a crisis of liquidity. This adds to the already risky nature of short selling, which Chapters 3 and 5 discussed at length.

What will the impact of the reintroduction of single-stock futures in the US market be? Single-stock futures were traded in other domestic exchanges (UK, Sweden, South Africa, Hong Kong and Spain) even before the CFMA re-introduced them in the US system.[80] It is apparent, however, that the repealing of the ban in the US is a major market development both for the size and scope of the US domestic markets and for the effects it will have on other markets worldwide. As is already happening with LIFFE in London, in fact, single-stock futures can be based, not only on domestic, but also on international stocks – so called

[77] At the time of writing, the CFTC and the SEC are still working to achieve a level playing field between the rules governing option exchanges and those governing futures exchanges.
[78] This study has been financed by the CSFI and LIFFE.
[79] This is particularly true in the UK market: as in the UK futures contracts are not considered securities for tax purposes, they are not subject to the payment of the stamp duty, which instead is imposed on stocks and stock options.

cross-border or universal single-stock futures. Market participants expect it to be one of the biggest innovations in equity investing. The above-mentioned CSFI paper defines single-stock futures as 'one of the most interesting developments in the field of financial derivatives for many years' (Lascelles 2002: 2). The CBOE Chairman defined them as 'the next frontier in the investment world' (CBOE 2001), while *The Financial Times* talks of 'the most sweeping change in the law governing US futures trading since the mid 1970s' (*The Financial Times* 2003).

For the time being, the amount of SSF trading – considering all the countries where SSFs are traded – is still tiny. One must remember, however, that SSFs are exchange-traded derivatives and that the bulk of derivatives are traded over-the-counter. This means that SSFs will never reach the level of trading that takes place in OTC products.[81] Moreover, SSFs in the US have just started being traded. The three major derivative exchanges, the Chicago Board Options Exchange, the Chicago Board of Trade and the Chicago Mercantile Exchange, formed the joint venture One Chicago to trade SSFs only in mid-2002 (Lsacelles 2002: 13). It is therefore plausible that, once introduced, their growth will be rapid, particularly given the enormous boost that equity investing has received in the US.

Moreover, the reintroduction of SSFs will not only affect the US market. As we have seeen, LIFFE in London has teamed up with NASDAQ to launch 'universal' single-stock futures, which are based on several dozen world-class stocks (Lascelles 2002: 13). Thus SSFs are likely to become an instrument of speculation that, like many others, cut across national boundaries. Regulation, however, remains national. The possibility of trading SSFs on stocks from all over the world will create a situation in which regulators in charge of SSFs

[80] In the UK market, SSFs have been traded since the early 1990s. Other markets in which single-stock futures have been traded for more than ten years are Sweden, South Africa, Spain and Hong Kong. The LIFFE programme in London is the only one that has launched cross-border SSF.
[81] Only one eighth of all derivatives trading takes place through organised exchanges like LIFFE. The rest is over-the-counter transactions (Lascelles 2002: 13).

are not the same as those in charge of the underlying stocks. This would require co-ordination among regulators of different countries, which is rarely in place.

Another important question is whether SSFs will remain an instrument of speculation or an instrument of insurance. Derivatives are usually defined under the double status of 'risk-controlling' and 'risk-enhancing' instruments, though Chapters 1, 2 and 3 explained the shortcomings in this dichotomy. We have already seen within this chapter that futures are instruments to gain exposures more than insurance. Are there any statistics on the role of single-stock futures? According to the above-mentioned CSFI study, in Hong Kong, where SSFs have been traded since 1995, 70 percent of trades are for speculative purposes and 30 percent for hedging (Lascelles 2002: 5).

SSFs also raise issues of 'optimality' from a social point of view. 'SSFs give investors and traders a way to engage in tax and regulatory arbitrage from which either the tax or the regulatory authorities could be the losers. [...] the economy as a whole could be worse off' (ibid: 15). Some possibility for tax and regulatory arbitrage were already discussed above: lack of stamp duty for SSFs traded in London; lower fees, which means lower fees paid to regulators and hence the community; avoidance of the regulatory restrictions in place in the cash markets (up-tick rule); and so on.

If there are plenty of reasons to be wary of SSFs, why have they been re-introduced? Not surprisingly the answer that is given by regulatory and market participants is similar to that given to justify the positive role of hedge funds: SSFs make the market more efficient by pushing prices towards their equilibrium level. As SSFs enhance the possibilities of seeling short, they are said to increase the liquidity of the underlying stocks and ensure that their prices always reflect fundamental values. According to this argument, the efficiency-enhancing impact should compensate for the potential social costs brought about by tax and regulatory arbitrage.

The other consequence of the repeal of the ban on single-stock futures is that the up-tick rule, which is in place in organised exchanges throughout the US as a form of restriction on short selling, will be invalidated. Before explaining why this will happen, it is necessary to outline the working and rationale of the up-tick rule. The up-tick rule (Rule 10a-1) affects short sales of any security registered on a national securities exchange in the US (listed securities). This rule is a consequence of the Securities Exchange Act of 1934, which granted the SEC the authority to regulate short sales of listed securities for the purpose of investor protection. Rule 10a-1 says that it is possible to sell short a listed security only 'at a price above the price at which the immediately preceding sale was effected (plus tick) or at the last sale price if it is higher than the last different price (zero plus tick)'[82] (SEC 1999: 4). Beyond the technical jargon, this provision precludes short selling of a listed security at successively lower prices so as to prevent investors from driving down the market.

Many blamed the 1929 stock market crash on the strategy of selling securities short in an attempt to drive down their price. It became a core issue in the post-Depression debate that brought about the reform of the Investment Companies and Securities laws in the US (Investment Company Act of 1940, Securities Act of 1934, Securities Exchange Act of 1933, see also Chapter 2: 76). The post-Depression era can be seen as the lowest point of consensus on the desirability of short selling, exactly because of the memories of the recent depression. The Congress 'made no determination about [short selling] permissibility' but delegated authority to regulate it to the SEC (SEC 1999: 3). It is at that time that the SEC introduced the up-tick-rule. In 1963 the Congress required the SEC to carry out a study of the relationships between changes in short positions and subsequent price trend (ibid: 5). The request of such a study suggests that the Congress worried that the up-tick rule might not stop the process of price manipulation for which it was designed. In effect the study

proved that 'the ratio of short sales to total volume increases in a declining market' (ibid: 5), which means that a downward trend can be triggered despite the up-tick rule. In 1976 the SEC proposed the elimination of the up-tick rule, but market participants, including the major exchanges, NYSE and AMEX,[83] strongly opposed the suspension of the up-tick rule, arguing that it provides important protection for investors that should not be removed. In 1991, the House Committee on Government Operations released a report on short selling that once more questioned the effectiveness of the up-tick rule and asked whether a similar rule should be implemented for NASDAQ trading. Following this report, the NASD proposed a short sale rule covering NASDAQ National Market System (NMS) securities, which are those securities that have similar characteristics to listed securities but are traded on the NASDAQ. The SEC approved this rule (Rule 3350) in 1994. Rule 3350 is not as restrictive as the up-tick rule, as it 'prohibits short sales by NASD members in NMS securities at or below the best inside bid as shown on the NASDAQ screen when that bid is lower than the previous best inside bid' (SEC 1999: 5). The 1991 report also called for collection of data on short selling activity and various forms of reporting requirements. As a consequence, both the NYSE and the NASD adopted rules requiring members to report data on their short sale activities. (These data are reported on a fortnightly basis in the *Wall Street Journal* under the name 'short interest in a stock'.)

Since then the SEC has not taken any further action on short selling. At the time of writing, the up-tick rule (Rule 10a-1) applies to listed securities, while Rule 3350, which is less restrictive than Rule 10a-1, applies to NASDAQ MS securities. This leaves out over-the-counter securities as well as short selling carried out through derivative markets. This means that no short sale rule applies to futures exchanges. In 1999, the SEC issued a concept release to collect opinions on the amendment of the up-tick rule (SEC 1999). The concept

[82] Zero plus- (or up-) tick means that, if there is no change in the last trade price of the particular stock, a short sale can be executed only if the previous trade price is higher than the trade price that preceded it.
[83] Respectively the New York Stock Exchange and the American Exchange.

release was asking market participants whether they thought that Rule 10a-1 should be maintained or lifted and, in general, whether short selling should be more or less regulated. The total letters of comment that the SEC received can be broadly split into (1) letters in favour of lifting the up-tick rule; (2) letters in favour of extending the regime of exemptions from the rule; (3) letters in favour of introducing short selling restrictions in other markets beyond those of the NYSE and NASDAQ; and (4) letters asking to regulate short selling more forcefully (SEC Letters of Comments 1999-2001). Most of the comment letters could be ascribed to the first and second categories. Banks and large institutional investors were generally in favour of lifting the rule, while smaller players were in favour of tightening regulation. At the end of 2002, the SEC has not implemented any amendment to Rule 10a-1. In the meantime, the Congress passed the CFMA.

How can the re-introduction of single-stock futures affect the debate on the short sale rule? As said before, the up-tick rule (and even the NASD rule) only exists for stock exchanges, not for futures exchanges. With the reintroduction of single-stock futures, those willing to sell short a stock can move to futures markets, where they do not have to wait for the price of the stock to go up before shorting it. As regulators confirm, 'single stock futures are a way to get around the up-tick rule' (Anonymous 17, interview 2002). Since the passing of the CFMA, market observers were expecting that the up-tick rule would be lifted in national exchanges or modified as a consequence. Is it going to happen?

Though the SEC has not issued a new rule for national exchanges and NASDAQ, in a speech in May 2002, Anne Nazareth, Director of the SEC Division of Market Regulation, briefly outlined what will be the outcome of the 1999 concept release (Nazareth 2002). The up-tick rule will be eliminated and replaced with NASD Rule 3350, which applies to the exchange of NASDAQ NMS stocks. This, she said, will be done in view of NASDAQ's plan to become a national securities exchange. One single rule will provide a standard

treatment for all national securities exchanges. Ms Nazareth says that this is also due to the 'impending commencement of trading in single stock futures' (ibid). Yet Rule 3350 implies a lower restriction on short selling for listed securities. Ms Nazareth acknowledges that this will mean a sort of 'short sale relief':

> If the Commission does determine to effect *short sale relief* it will be incumbent on all of us to convey to investors that we are not abandoning the goals of short sale regulation, but rather updating the rule to reflect market developments, and shifting regulation to the areas where it is most needed. By doing so, we can ensure that investor confidence remains high, and that our markets, in turn, remain strong (ibid, my italics).

The areas that she referred to as 'most in need of regulation' are the NASDAQ SmallCap securities and OTCBB market – e.g. small capitalisation securities, also called 'penny stocks'. In those markets, in fact, no short sale restriction exists and abuses and manipulation have been noticeable (Pinegar, interview 2001; Marshall, interview 2001). The introduction of a rule in these markets is certainly most welcome, though these markets represent a small fraction of securities trading. The short sale relief for listed securities, instead, is a major event, which will add to the already weak impact of current short sale restrictions.

Seeing a clear and intentional plan behind these two events – the repeal of the Shad-Johnson Accord and the short sale relief – might sound like the imposition of a particular ex-post view of the events. But it is certainly plausible to say that the ban on single-stock futures was lifted and the up-tick rule is in the process of being modified because a new, more positive, understanding of short selling has come to dominate financial debates and theories (this also answers the point raised in the previous section). Particularly after the Internet bubble, short selling started being described as an efficiency-enhancing mechanism of financial markets (for the same reasons outlined in the case of hedge funds, see section 3.2). Commentators increasingly argued that short selling should not be considered more destabilising than buying long. Most economists and regulators in Washington share this view. According to (Anonymous 17), 'speculators are very useful in futures markets to

bridge the gap between long and short positions. They provide liquidity to the market. Only-long futures can be very bad as well. Speculators are morally neutral. It is impossible to say that the seller is bad because he/she is forcing the market down' (Anonymous 17, interview 2002). This view is shared not only by regulators, economists and market practitioners, but also by some influential NGO people. Randall Dodd, Director of the Derivative Strategy Centre in Washington, pointed out that 'short selling is as much of a problem as buying long. I cannot see why regulators should target 'selling short' and not 'buying long'' (Dodd, interview 2002).

This research argues that this kind of reasoning can be misleading. Buying long, intended as the buying done by the mass of ordinary investors, cannot be compared to selling short. It is true that in many cases the long side has to be read in conjunction with the short selling side (see Chapter 5, case of the Internet bubble). In the case of the bandwagon strategy, for instance, stocks are bought on the expectation of selling them short later on, so that the same group of investors influence the timing of the buying and of the short selling. Buying long and selling short, however, are not equivalent market actions. Selling short means expressing a negative judgement about the prospect of a company (equity market) or a country (currency market and equity market). While this might be justified under certain circumstances, it is highly dangerous if conceived as a 'normal' way of playing the market. Short selling indeed has increasingly been conceived as a smart technique to make money and to win no matter what the market does. For the company or the country at the receiving end of short selling, this situation can be highly unfair if valuations are curtailed without any fundamental reason to justify it. Finally, short selling is subjected to less reporting requirements than buying long (Chapter 5: 257).

A good example of the dangerous effect of short selling is given by the market valuations at the end of 2001 and 2002. Independent of economic fundamentals, company valuations have been influenced by a massive and continuous short selling that have kept short interest

negative for at least 33 months in a row (the longest bear market in history, longer than the 1929 Depression).[84] It would be enough to analyse the *Wall Street Journal* 'short interest column' over that period of time to evidence that short positions have been consistently higher than long positions. This is like saying that valuations have been systematically curtailed by short selling. Unfortunately, the short interest column only reports movements in the cash markets and ignores those in derivative and OTC markets. Despite that, it gives an indication of market trend over that period of time. Economists like (Anonymous 17) might see this movement as the expression of collective negative expectations – as Keynes would say, as a barometer of 'market spirits'. These expectations, however, are hardly the expression of a collective judgement, but rather of an elite of investment managers. The manager of a financial boutique interestingly observed that the tone of most articles on short selling is pedantically didactical. He says: 'It seems to me that commentators want to inform investors that there is a new way of playing the market – shorting it – and that this is a 'normal development', even a positive one, which reflects market expectations' (Anonymous 18, interview 2002).

This digression on short selling is useful to understand why the Commodity Futures Modernisation Act perfectly fits the growing acceptance of the role of hedge funds and short selling. In the wake of the Internet bubble, short selling – and all the instruments reproducing this concept – started being cited as a possible way of offsetting the highly inflated dot.com prices. As the *Wall Street Journal* wrote in May 2000, 'a solution is at hand, a way to bring short selling to the masses. It's called single-stock futures' (Jenkins 2000). The article referred to the fact that as the buying side was so unrealistically inflated, small investors should have a way to express a negative as well as a positive vote. According to the article, short selling should stop being the domain of hedge funds and other institutional investors and instruments should be available for small, retail investors to

[84] This period is calculated from March 2000 to December 2002.

do the same. Single-stock futures were seen as precisely this type of instrument and, hence, as a new form of democratisation of the stock market.

It is undeniable that, precisely because of the changes in the mode of investing described throughout this research, there will be a high demand for single-stock futures. The financial-boutique manager quoted above concluded by saying that he would like to have access to short selling 'as much as hedge funds and all the pros do. If short sellers are going to be dictating market valuations as they are doing now, I would rather join them' (Anonymous 18, interview 2002). However, it is doubtful whether single-stock futures will ever become an instrument of democratisation of the stock market and, most importantly, whether this can be called 'democratisation of the market' to begin with.

Regulators in Washington, as well as journalists and market observers, think that single-stock futures will be the perfect instruments for institutional investors, hedge funds in particular, but not for retail investors or depositors. Who is going to use them most? (Anonymous 19) answered: 'by and large institutional investors. Hedge funds might use single-stock futures to circumvent the up-tick rule; mutual funds might use them to hedge their positions, and so on. Retailers, on the contrary, will join only when the market develops, if they will ever do it' (Anonymous 17, interview 2002). Of the same view is William Brodsky, Chairman and Chief Executive of the Chicago Board Options Exchange (CBOE 2001). Mr Brodsky 'anticipated that single-stock futures would be primarily an institutional product. He doubted they would have much appeal to retail investors' (Witte 2001). Hedge funds indeed have been the first to enter the single-stock futures market. A hedge fund using a strategy entirely based on single-stock futures was launched in early 2002 (Gallo 2002b).

On the other hand, it is not straightforward that an extension of short selling to retail investors would be a form of democratisation of the market. Considering the unlimited

losses that traders using single-stock futures face, SSFs are more likely to reduce instead of increasing the wealth of smaller investors. The Internet bubble is a perfect example of this and a warning for the risks small players can incur.

The re-introduction of single-stock futures is only one of the provisions of the Commodity Futures Modernisation Act. The CFMA is a complex piece of legislation whose purpose, as its proponents said, was to revolutionise derivatives markets and 'eliminate the sources of legal uncertainty that impede innovation in product development' (CFMA 2000). Legal certainty in this context means that contracts have to be enforceable in order to give market participants certainty of execution. Therefore, contracts have to be executed even if they do not conform to any particular standard or model. Indeed, the purpose of the act was to eliminate the need for any standardised contract. It is market participants that will decide the model and the rules, case by case, through a process of 'self-certification' (CFMA 2000; Anonymous 17, interview 2002). Exchanges and all investors trading in them are going to be deciding about new contracts and products. As (Anonymous 17) pointed out, 'exchanges are the front lines, they set their own limits and we [regulators: SEC and CFTC] only provide guidelines. In this way, we are deregulating' (Anonymous 17, interview 2002). Providing legal certainty therefore means providing a legal foundation for deregulation and for new derivative products and markets to develop.

What the CFMA wants to achieve is to open up the range of possible derivative contracts, to innovate, and let participants be creative. This, however, means abandoning any effort to standardise OTC contracts. Any contract can and will be executed. 'This facilitates innovation, in the words of the promoters of the bill, but you do not want to grant the possibility of creating new and less controllable derivative instruments' (Baker, interview 2002; see also Dodd 2000).

The Act is full of references to the necessity of streamlining US financial markets to make them competitive with the rest of the world (reference is to London, which has never banned single-stock futures). In the words of its promoter, Agriculture Risk Management Subcommittee Chairman Thomas Ewing, 'the cooperation of the industry, the administration, and congressional leaders has produced an agreement that will ensure America will remain the leader in the world's financial community' (CFMA 2000). The Bill was certainly a unanimous effort. As Ryan Weston, Staff Director of the US House Committee on Agriculture, highlights, the Bill was enacted with 377 votes out of 435. He says that, 'there was a strong bipartisan support for the Bill from the entire House. All competing interests (futures exchanges, banks, swaps, equities and securities exchanges) were present' (Weston, interview 2002).

By all competing interests Weston means exchanges and banks. For a Bill that is going to revolutionise the way financial markets work, one would have expected the participation of at least some trade unions, corporate representatives and, given the objective of bringing short selling to retail investors, some consumer associations. Concerns, however, were of a different nature. As Mr Weston says, 'the biggest concern was that single-stock futures had in principle fewer margin requirements than stock options and that this would have meant that futures and option exchanges were not treated on an equal footing' (Weston, interview 2002). This was the most debated point, which saw the SEC and CFTC working closely to find a solution (on this point see also MacKenzie 2002). No other concern or interested party was mentioned.

The exclusion of many stakeholder groups is also evident in the consultation procedure that the SEC used to gather comments on the reform of the short sale rule (concept release). As seen in Chapter 4, issuing a concept release and calling for comments on a proposed change of rule is a common SEC procedure. In principle, any interested party is invited to send comments. Needless to say that on matters such as short selling it is mainly brokers, banks,

institutional investors and corporations that send comments to the SEC. This is mainly due to the perception that financial matters are the domain of a few specialists and direct market participants. Consumer associations, for instance, or those representing broader sectors of civil society are often unaware of the impact that certain regulatory decisions can have on ordinary people and on the economy at large. This explains why it is only direct market participants that send comments and why, as a consequence, these comments are generally in favour of further deregulation.

Further research is warranted on those regulatory initiatives that, in different ways, contribute to dismantle the regulatory structure put in place in the US during the post-Depression years. The geographical scope of the research should be expanded too. The impression is that regulatory debates in other countries are undergoing a similar process of deregulation. Additional research is warranted to find out the relevance of these moves that are set to continue.

6.4 Conclusion

This chapter has shown another way by which regulators have blessed the continuation and further spread of a hedge fund mode of investing: while tackling hedge funds with *ad hoc* initiatives at both the domestic and international levels (though with scant results), in other industries and contexts the very techniques that hedge funds use have been promoted and legitimised. This has happened through legislative (CFMA) or political (Myners Report) actions. These actions, however, did not make it to the debate in Washington or Basel. Using Foucault's definition, they constitute an unsaid in the regulatory discourse of hedge funds.

According to Foucault's definition of discourse as apparatus, what is not said in a discourse is as important as what is said. In this particular case, the unsaid confirms the trend towards

the normalisation of hedge fund strategies as well as regulator blessing for this trend. Regulatory authorities have indeed facilitated this normalisation under the assumption that it would bring efficiency to the market. The Commodity Futures Modernisation Act of 2000 and the debate on the reform of the mutual fund industry, which were analysed in this chapter, share a common feature: both have been justified as attempts to modernise these industries, bring higher returns and efficiency, and streamline the market. As in the case of hedge funds, the efficiency justification has been predominant. There has been no mention on the distributive impact of these regulatory actions (the 'who gets what') as well as their consequences on the real economy.

This chapter also highlighted a further point. In the governance of global finance, regulation has increasingly become synonymous with deregulation. This is apparent in the case of the Commodity Futures Modernisation Act. Its purpose to provide legal certainty to the derivative industry should be qualified as 'deregulation' of the hedge fund industry. The provision that all derivative contracts will be enforceable and that it will be up to private actors to define the terms of these contracts is only another move to further delegate authority to financial players. In the case of mutual funds, regulatory and policy-initiatives (Myners Report) are increasingly undertaken to increase the performance of the industry rather than to make the market work according to principles of investor protection and market integrity.

Theoretically, the chapter has explored another potential use of the concept of discourse as apparatus. Through the notion of the unsaid, discourse provides a concrete alternative to Lukes's two-dimensional view of power. As much as Lukes is concerned with non-decisions and what is kept outside the policy agenda, Foucault is concerned with what discourse does not say or prevents from being said. The concept of apparatus, however, goes beyond the two-dimensional concept of power. Instead of looking solely at what is *intentionally* kept outside the regulatory table – as the two-dimensional view does – a

discourse approach argues that issues can fail to be formulated because the structure of meaning in which actors operate prevents certain problems from being felt as such. Following this perspective, the chapter has uncovered some questions and problems that were not perceived as such during the regulatory debates in Basel and Washington, but that will have a bearing on the role of hedge funds and short selling in financial markets.

CONCLUSION

This concluding section reintroduces the main research question and argument of the thesis and explains how they have been developed throughout the chapters. This includes an analysis of how the theoretical framework set out in Chapter 1 has been supported by empirical evidence and can be considered as a useful schema for the analysis of the regulatory debate on hedge funds. The conclusions then move on to outline the main limitations encountered by this study, how they have been overcome and the implications for future research.

Argument and theoretical framework: their development in the analysis

This thesis has offered an analysis of the regulatory debate on hedge funds and of the reasons why an apparently destabilising instrument of financial markets has remained untouched despite the setting up of an international forum and various initiatives at both the domestic and international level. The thesis has attributed this failure of regulation to a decision-making setting that favours the interests of certain actors (the US administration and the transnational financial community) and to a structure of meaning that increasingly promotes self-regulation and due diligence as opposed to more mandatory approaches to regulation.

The thesis has answered the research question – why have hedge funds remained essentially untouched? – by providing three explanatory models of the outcome of this regulatory debate. The first model has been advanced in regulatory circles such as the IMF or the FSF and draws on the theory of mainstream financial economics. The second and third models have been elaborated in this thesis to provide a political economy account of the hedge fund

debate. To bring in the politics of the debate, the second and third models have drawn upon Lukes's analysis of power and re-elaborated it at the light of the IPE and IR literature.

Though privileging this political economy approach, the thesis has not argued that one explanation is a more *truthful* description of reality than the others. Instead, it has focused on their policy implications and the interests they promote. Following this line of enquiry, the thesis has concluded that the third explanation is most suitable to analyse issues of power in financial markets and to respond to the interests of the broadest range of stakeholders, especially those that are excluded from the market and from regulatory discussions.

The first explanatory model has argued that hedge funds remained unregulated because the empirical evidence on them did not point to the need for their regulation. By systematically emphasising the efficiency-enhancing role of hedge funds, this account has ruled out the reasons to regulate them. Chapters 2 and 3 showed that this explanation, which was dominant within the FSF, the IMF and US regulatory agencies, is rooted in the dominant thinking in finance. The comparison of regulatory documents and economic papers/textbooks has provided a clear support for this thesis. The third model precisely tackles this dominant thinking by analysing the power of the structure of meaning within which regulatory discussions took place.

The second explanatory model has argued that hedge funds remained unregulated because the dominant actors at the regulatory table opposed their regulation. The regulatory table was intended as the site where the regulation of hedge funds was to be debated. The thesis principally focused on the Financial Stability Forum in Basel and on the domestic process in Washington and explained the reasons for these choices. The dominant actors were identified with the US administration, among the direct members of the FSF Working Group on hedge funds, and with the transnational financial community (especially banking

community), among the private actors that most influenced the regulatory process. The US administration was more precisely referred to as a regulatory complex formed by the Treasury, the Federal Reserve and domestic regulatory agencies (SEC and CFTC). The transnational financial community was referred to as the most sophisticated and global segment of the investment and banking community and identified with big commercial and investment banks. In line with Underhill's definition of 'closed policy community' (Underhill 1997), the thesis has shown how these two sets of dominant actors were highly interrelated and jointly influenced the decision not to implement a more interventionist public regulation of hedge funds.

The third explanatory model has argued that the power to influence the debate went beyond the dominant actors at the regulatory table and the institutions superseding the process. Hedge funds remained unregulated because the structure of meaning within which discussions took place and problems were framed directed the decision-making process towards this outcome. This structure of meaning draws upon the concepts and theories of modern finance (Fama 1970, 1965; Friedman 1953), which in turn gave rise to regulatory practices in favour of a self-assessing market. Chapters 3 and 5 demonstrated that this structure of meaning has constrained policy options to such an extent that, even without a clear dominance by a group of actors, the range of feasible solutions would be limited to what this structure or discourse says.

The thesis has illustrated how each explanation leads to a different set of policy options. The fact of relating these accounts to their policy implications is one of the strengths of this theoretical framework. The first model leads to policy recommendations that rely upon private actors' due diligence and self-assessment of risk. This means letting financial players sort things out by themselves. The second model leads to policy options that favour a greater inclusion of developing countries and other stakeholder groups in decision-making processes in global finance. The third model leads to a rethinking of the very tenets of

financial market regulation and of the financial theories used to explain and govern the market. The latter set of policy options is deemed more likely to bring about solutions that are clearly different from the dominant neo-liberal approach to regulation. They are also the most ambitious ones. In order to challenge a whole structure of meaning or discourse, it is first necessary to understand the co-ordinates of knowledge that this discourse rests upon and what the discourse excludes or prevents from being said. In the case of the debate on hedge funds, as well as in many other debates in global finance, this means problematizing the very foundations of our contemporary financial knowledge. It is on the basis of this knowledge, rather than of the relative power of participating actors, that issues are created and addressed. Problematising this knowledge means critically engaging with financial theories and with the legal principles that underpin the regulation of financial markets. This is the major contribution of this research and, at the same time, the point that opens new research questions and demands further analysis, as will be explained in the following sections.

Overcoming difficulties

Several limitations have been encountered in carrying out this research project. Some of them are due to the secretive and complex nature of hedge funds and regulatory practices. Others are the inevitable consequence of breaking new grounds and experimenting with new theoretical frameworks for the study of the global financial governance.

As for the first set of limitations, three were particularly constraining. The first relates to the definition of hedge funds against other investment vehicles; the second to the assessment of their quantitative relevance (capital and number); and the third to the complex nature of their market practices. Overall, these limitations can be said to concern the collection of data and empirical evidence on hedge funds. Some authors refer to them as problems of 'data deficit' and more generally as efficiency problems (Scholte 2002). The second set of

limitations relates to the provision of alternative criteria to evaluate regulatory solutions. As most of the studies on the subject take efficiency as the only measure to assess regulatory solutions, it proved difficult to provide alternative perspectives without a strong theoretical support in the economics and political economy literatures. This section deals with these two sets of limitations, while the next one explores the avenues that are left open for future research in this area.

A first limitation was encountered in defining hedge funds. As pointed out in Chapters 2 and 3, it is difficult to know how many investment vehicles operate like hedge funds despite having another name or qualification. This adds to the already blurred distinction between hedge funds on the one hand and other investment vehicles such as banks, mutual funds, pension funds and insurance companies on the other. The research has solved this ambiguity qualitatively, that is, by pointing out the various ways in which hedge fund strategies can be reproduced (e.g. through derivatives). But it was impossible to solve the ambiguity quantitatively, that is, by pooling the various strategies together and measuring their quantitative impact.

A second limitation refers to the lack of official statistics on hedge funds. As a consequence, this study had to rely on data provided by private vendors, who in turn rely on the information voluntarily released by hedge fund managers. Chapter 2 described in detail the shortcomings of this method of collection: data can be manipulated upwards or downwards according to the specific interest of the data vendor; different vendors publish quite different data; and many databases are only accessible by the payment of subscription fees, which can be extremely expensive for an independent researcher. The solution that was adopted in this research was to draw on publicly available statistics and especially on those published by regulatory agencies, which have access to private databases.

A third limitation stems from the complex nature of both hedge fund and regulatory practices and from the need to consider regulatory developments in different industries. As explained above, different actors can implement hedge fund-like strategies and this made it necessary to look at regulatory developments across different industries. This means that a large number of rules and regulations were taken into account and assumptions were made on their links and combined effects on the market. Due to the level of expertise that is required in these matters, lack of precision or failure to evaluate the overall effect of a reform might have occurred. However, it would have been difficult to try and clarify all ambiguities, many of which are intrinsic to market regulation. Efforts were made to weigh most of the empirical evidence and its interpretation against the views of direct participants or experts in the sector. This was deemed sufficient for the purpose of this research. Despite this limitation, in fact, the study was able to show that there is a trend towards further liberalisation of hedge fund practices across different industries.

Apart from these more technical and data-related limitations, additional ones were encountered in the attempt to evaluate regulatory proposals according to criteria other than efficiency and performance. Chapter 3 argued against the use of efficiency criteria as the only basis to assess regulatory solutions. In particular, it warned that these criteria are biased in favour of a self-directed market and a non-mandatory approach to regulation. Principles such as social equity, justice and democratic accountability are instead not accounted for in current decision-making processes in finance. Their inclusion would lead to a re-thinking of the tenets of financial market regulation and would therefore be desirable.

The thesis has made an attempt to bring these criteria into the analysis. It has showed, for instance, how the non-regulation of short selling profoundly affects the distribution of wealth in favour of the most sophisticated and better-off market participants. It also showed that short selling is largely unaccountable, as, contrary to 'buying long', it is not subject to any disclosure requirement. More generally, the study has stressed that criteria of social

equity, justice and democratic accountability should be more influential in decisions concerning the regulation of financial markets. Further analysis could draw on the work already done on the social equity and justice concerns triggered by the operation of financial markets (see for instance Patomaki 2001; Scholte 2002; Scholte and Schnabel 2002)

Further work needs to be done to broaden the range of case studies, assess the validity of the conclusions advanced in this thesis and find a way to operationalise considerations of equity and democratic accountability. It is believed that the suggestions made in this thesis open the way to further methodological thinking on how to relate investment strategies and regulatory decisions in financial markets to the distribution/redistribution of income, wealth and opportunities. The problematisation of the main tenets of the regulatory discourse on hedge funds is a first step in this direction. Through the specific case of hedge funds, this problematisation showed the biases in contemporary discussions concerning reform of the Global Financial Architecture. The next section re-presents this work as one of the major contributions that this thesis can offer to research in global finance.

Implications of this study for future research

The Introduction drew attention towards three main contributions that this research makes to the literature on the governance of global finance: an empirical contribution, which consists in the analysis of a regulatory debate that has not been explored before; a contribution to cross-disciplinarity, especially between the fields of International Political Economy and Financial Economics; and a contribution to the understanding of power in financial markets, through the emphasis on the structure of meaning or discourse. This section briefly analyses the implications of the first two contributions and then moves on to focus more closely upon the third contribution.

With regards to the first contribution, the thesis has analysed an ample range of economic theories, papers, textbooks, market laws, regulations, and has collected an equally broad range of opinions through elite interviews. To the best of the author's knowledge, this material has not been analysed before in any study in International Political Economy – nor has it been the object of much academic interest in Finance or Law. This thesis, therefore, can be seen as an original empirical contribution to IPE studies of financial market regulation.

As anticipated in the Introduction (page 19), this thesis can also be seen as an attempt to foster cross-disciplinarity between the neighbouring fields of IPE and Finance (and partly between IPE and Law). Major implications for future research are expected to come from the comparative analysis of critical perspectives in IPE and Economics/Finance. The thesis has drawn upon several heterodox contributions to the study of Finance and Economics. A dialogue has been initiated with scholars working within the *Post-Autistic Economics* movement, the *Association for Heterodox Economics* and the *Alternative Perspectives on Finance and Accounting Journal.* This has provided general inspiration for the argument of the thesis and for the critique of economic theories, but has also set the foundations for further research into these contributions and their relevance for IPE.

It is the third contribution, however, that is likely to have more implications for future research on the governance of global finance. The thesis has argued that an analysis of the structure of meaning or discourse helps understand decision-making and policy-making processes in global finance. By critically engaging with the meaning assigned to the principles, institutions and practices superseding the regulatory debate on hedge funds, the thesis has shown the power of this structure to constrain regulatory choices. The fact that this structure of meaning impinges upon many other regulatory debates in global finance makes this study of more general applicability.

The thesis firstly described the main tenets of this regulatory structure. It identified them with financial stability, due diligence, market efficiency, equilibrium and the individualistic idea of risk. It then analysed how these tenets direct regulatory choices in favour of an increasingly self-regulating market. It showed how the balance between public and private market authority and – more fundamentally – between collective and private interests has largely shifted in favour of the latter. The increased colonisation of the public domain by private market forces poses serious challenges for 'the need of political systems for legitimacy in terms of economic opportunity, institutions and modes of governance, and distributional outcome' (Underhill 1999). By summarising the elements of this regulatory structure and their impact on the hedge fund debate, the remainder of the section highlights how this analysis can contribute to research into the regulation of financial markets.

The critique of the current meaning of *financial stability* is particularly significant, since financial stability has acquired an unprecedented importance in global finance decision-making processes. Concerns about financial stability have far exceeded those for equity and democratic accountability. The analysis offered in this thesis provides the starting point for an endeavour to trace the origins of this emphasis on financial stability, what it says about current political priorities in global finance, and its implications for the real economy and the distribution of wealth at the global level.

Chapter 5 showed that financial stability has become 'the' concern in discussions of the Global Financial Architecture: the prevention and management of any sort of market failure and financial crisis have been subsumed under its heading, as is evidenced by the agenda of, for instance, the FSF and the UNDP. Chapter 5 showed that the stress on financial stability is a direct consequence of the resurgence of a market-led, as opposed to a government-led, financial system. It was only when this resurgence was complete (at the end of the 20th century) that episodes of financial instability became more prominent (Crockett 2001). Mechanisms to ensure financial stability thus became the counterbalancing effect of

increasingly market-driven regulation. This explains why financial stability has become the prominent concern of advanced markets and is promoted as main public good of finance. It also explains why the FSF Working Group on hedge funds has privileged concerns for financial stability over issues of market dynamics and integrity – which are instead major concerns for emerging markets and developing countries.

Due diligence becomes inextricably linked to this concern for financial stability. When measures to achieve financial stability are discussed, they are made dependent upon responsible behaviour (due diligence) by each market player. In circular reasoning, the cause of instability and the restoring of stability are made identical: reliance on individuals' self-assessment of risk and due diligence.

As for the concept of *efficiency*, the specific meaning that efficiency assumes in finance is that of a state of the market in which prices fully and constantly reflect the fundamental value of assets. In such a state, investors are fully rational, that is, they make decisions on the basis of fundamental values. Fama and Friedman maintain that such a state can exist to an extent.

Contrary to stability, the concept of efficiency has long been challenged by IPE and Economics scholars alike. Criticisms have generally focused on the impossibility of reaching such as state as well as on its desirability. Less debated is the fact that this notion of efficiency directly leads to regulatory preferences for a self-assessing market and due diligence. This is well evident in the case of hedge funds. Hedge funds are said to be agents of efficiency, in the sense that they bring efficiency back to the market when real market conditions diverge from it. Because of their contrarian trades, they are also said to bring liquidity to the market, e.g. by taking the other side of the trade when the market is unbalanced (there is too much buying or too much selling). This justifies the opposition to any regulation of hedge funds, as regulation would hinder their role as efficiency and

liquidity providers. This also feeds into the argument that the market can readjust towards efficiency without any external (public) intervention and that those interventions are only harmful and counterproductive.

In turn, both financial stability and efficiency stem from an understanding of the market that is linked to the idea of *equilibrium*. The general- or one-equilibrium economics – that is, the idea that the market eventually reaches one equilibrium point – is still the foundation of any model, proposal, or view that can be entertained in circles like the FSF. Chapter 5 showed how this orthodox resilience has direct practical implications: for instance, the strenuous defence of short selling comes from the idea that the short side and the buying side are symmetrical, that they will always meet in an equilibrium point and that distortions are only temporary.

The last tenet of the regulatory structure that was questioned in the thesis is the *individualist notion of risk* prevailing in contemporary finance. Chapter 5 showed that, despite the fact that the whole debate on financial stability emphasises the idea of systemic risk, risk is conceived in very individualistic terms. In principle, systemic risk is supposed to include those financial risks that affect the 'system'. For regulators and supervisors this mostly means preventing the contagion of financial troubles from one firm to the others. The way they usually go about it is by supervising the risk management system that each institution has in place and imposing higher capital ratios for riskier activities. In this way they hope, if not to restrict the risk-taking ability of financial institutions, at least to get them to hedge for the risk they take. This, however, leaves aside many other risks that regulators (and society) should be concerned with.

According to this idea of risk, preventing systemic risk means ensuring that all market participants cover, or hedge, for the risk they individually take. Making a comparison with environmental studies, it would be like asking polluting companies to protect themselves for

the risk they take without caring for the impact of their activities on the broader environment and on non-companies. The individualistic nature of risk is also evident in the primary emphasis on crises, intended as the abrupt occurrence of a destabilising event, rather than on the day-to-day impact of certain financial strategies. Making another comparison with environmental risk, it would be like focusing all worries on the occurrence of another Chernobyl without considering the effects of day-to-day nuclear pollution and the necessity of the reduction/elimination of nuclear waste. This is exactly what happens in finance: the day-to-day effects of financial speculation are rarely (if ever) studied and even more rarely considered for the risk they pose in terms of wealth loss or redistribution of wealth across society (e.g. Internet bubble).

These elements of the structure of meaning directed regulatory choices in Basel. One of these choices was to privilege the *indirect regulation* of hedge funds. It is worth emphasising this concept, as it is expected to play a leading role in future regulatory arrangements in global finance. Regulators in both Basel and Washington have used this concept to delegate to banks the task of indirectly regulating hedge funds. Alan Greenspan brought it forward in 1998 when he said that hedge funds should be regulated 'indirectly through the regulation of the sources of their funds' (Greenspan 1998). Since banks are hedge funds' main counterparties, the argument goes, their use of due diligence would be enough to prevent hedge funds from destabilising the market. The thesis, however, has shown that, due to the multifarious interests banks hold in the hedge fund industry, they might have no incentives to perform due diligence and properly assess risk, as regulators expect them to.

The contribution of this analysis also goes beyond the particular case of hedge funds and suggests the need for greater research on the function of banks in the current financial system. Banks are generally classified as conservative investment vehicles. Mainstream economics has accustomed us to think of banks as instruments working for the sake of

depositors and shareholders and neutrally executing their clients' orders. This idea is embedded in economic theory as well as in the regulation of advanced markets. However, this thesis has shown that banks play an increasingly crucial role in financial speculation. Banks – especially global commercial and investment banks – are becoming giant financial players, whose interest lies less in the provision of credit and funding to the real economy and more in trading and in the provision of financial services (e.g. prime brokerage). Chapters 3 and 5 showed that it is in their quality of prime brokers that banks gain the highest returns from their business with hedge funds. These returns were seen as a reason for banks to forget about due diligence and to join instead of fighting hedge funds. The more hedge funds trade – and the more aggressively they do so – the more banks gain commission fees on these transactions. This impinges on the effectiveness of banking supervision and regulation: supervisors are increasingly relying upon banks to indirectly regulate hedge funds, but this reliance can be misplaced if banks are the first to profit from the non-regulation of hedge funds.

It is clear that this raises questions, not only regarding the effectiveness of indirect regulation, but also regarding the function that banks perform in the current financial system. Several questions could be raised in future research: What are banks for in comparison with what they were for 60 or 70 years ago? Are banks safe places to keep one's money these days? Is the widespread use of hedge funds by banks a source of instability, even a potential threat to the whole system, and a source of further polarisation of wealth and income? Are we back to the pre-1929 situation, when banks were not regulated at all? The inclusion of these questions in future research on the governance of global finance is warranted, especially as banks are diversifying their role and increasing their importance in financial markets. It would also be worth asking whether the principle of indirect regulation applies to other contexts and industries outside banking supervision – e.g. securities firms, investment management, etc.

By critically engaging with the structure of meaning, this thesis has problematised the way many crucial aspects of the governance of global finance have been addressed in various institutional settings. For instance, it has warned against taking the concern for financial stability at face value and looked at the way this concern discriminates against other issues and preoccupations that should occupy a central place in regulators' and policy-makers' agenda. By challenging the way the regulatory problem of hedge funds has been formulated, the thesis provides useful considerations to be applied to other debates in global finance too.

LIST OF INTERVIEWEES

The fieldwork was developed in three phases. The first consisted of learning interviews, conducted in order to acquire acquaintance with the practice of hedge funds in particular and investment management in general. The second phase looked at the hedge fund regulatory debate in Washington and at the case studies of the 'unsaid' (Chapter 6). The third phase focused on the regulatory debate at the Financial Stability Forum in Basel. To highlight the evolution of the research fieldwork, interviewees will be listed according to the time and phase of the interview rather than in alphabetical order. Place, date and modality of the interview (face-to-face, telephone or email contact) will be specified next to the name and qualification of the interviewee. In the text of the thesis, interviewees are identified with their name and time of the interview (e.g. 'Mr X, interview 2002). Their qualifications are detailed in the list below. They are sometimes reported in the text of the chapter, next to their contribution or in a footnote, if this is deemed important for the discussion. Four interviewees asked to remain anonymous. In this case, their name will not appear in the list below. A larger group of interviewees asked to be quoted as anonymous for certain statements only, while they agreed to have their names listed. A separate list with full details of each anonymous statement is submitted separately to the internal and external examiners.

LEARNING INTERVIEWS

Ferenc Sanderson	Director of Research, **Hedge World Research Institute**. Rye, New York. December 21, 2000 and September 6, 2001. Email contacts.
Michael Ocrant	Editor in Chief, **MAR/Hedge**. New York. September 26, 2001. Telephone interview.
Robin Gross	Senior Counsel, Office of the Chief Counsel, Division of Investment Management, **Securities and Exchange Commission**. Washington D.C. September 26, 2001. Telephone interview.

David Friedland	President, **Magnum U.S. Investments** Inc., Miami. September 30, 2001. Telephone interview.
Richard Troy	Chief Executive Officer, **Cell Pathways** Inc. Melville, New York. October 3, 2001. Telephone Interview.
Hiroshi Nagata	Consultant, **Albourne Partners Limited**. London. October 10, 2001. Face-to-face interview.
Guy Ingram	Consultant, **Albourne Partners Limited**. London. October 10, 2001. Face-to-face interview.
Kevin Pinegar	Lawyer, **Durham Jones & Pinegar Law**. Salt Lake City. October 12, 2001. Telephone Interview.
Edwin G. Marshall	Chairman of the Board, Chief Executive Officer, **Medizone International Inc.**, San Francisco. October 13, 2001. Telephone interview followed by fax and email contacts.
Michel Chossudovsky	Professor of Economics, University of Ottawa, and Editor, **Centre for Research on Globalisation**. Ottawa. November 5, 2001. Telephone interview.
Jaakko P. Karki	Director of Research, **International Asset Management** (IAM). London. February 13, 2002. Face-to-face interview.

SECOND PHASE: regulatory debate in Washington + case studies of the Commodity Futures Modernization Act (CFMA) and mutual fund industry

Randall Dodd	Director, **Derivatives Study Centre**. Washington D.C. March 7, 2002. Face-to-face interview.
Anonymous 13	Washington, D.C. March 7, 2002. Telephone interview.
Dean Baker	Co-Director of the **Centre for Economic and Policy Research**. Washington D.C. March 8, 2002. Face-to-face interview.
David Ebersole	Professional Staff, Committee on Agriculture, **US House of Representatives**, Washington D.C. March 8, 2002. Face-to-face interview.
Edward J. Rubenstein	Senior Special Counsel, Investment Management Division, **Securities and Exchange Commission** (SEC), Washington D.C. March 8, 2002. Face-to-face interview.
C. W. Cummings	Office of the Chief Counsel, Division of Trading and Markets, **Commodity Futures Trading Commission**. Washington D.C. March 11, 2002. Face-to-face interview.

Thomas M. Leahy	Industry Economist, Division of Economic Analysis, **Commodity Futures Trading Commission**. Washington D.C. March 11, 2002. Face-to-face interview.
Barbara Matthews	**Institute of International Finance, Inc**. Washington D.C. March 11, 2002. Face-to-face interview.
Subir Lall	Economist, Global Markets Division, International Capital Markets Department, **International Monetary Fund**. Washington D.C. March 13, 2002. Face-to-face interview. Email follow-up on May 28, 2002.
Ryan Weston	Staff Director, Committee on Agriculture, **US House of Representatives**, Washington D.C. March 14, 2002. Face-to-face interview.
Lorenzo Garza	Financial Analyst, Division of Banking Supervision and Regulation, **Board of Governors of the Federal Reserve System**. Washington D.C. March 15, 2002. Face-to-face interview.
Sebeth I. Siddique	Supervisory Financial Analyst, Division of Banking Supervision and Regulation, **Board of Governors of the Federal Reserve System**, Washington D.C. March 15, 2002. Face-to-face interview.
David Bennett	Risk and Research Department, **Financial Services Authority**. London. March 22, 2002. Face-to-face interview.
David Raikes	Risk and Research Department, **Financial Services Authority**. London. March 22, 2002. Face-to-face interview.
Robert Clow.	**Financial Times** Correspondent from Wall Street, New York. Commentator on hedge funds. New York. April 3, 2002. Telephone interview.
Anonymous 18	Private Banking, Italy. April 20, 2002. Face-to-face interview plus follow-up email contacts.
Anonymous 14	**Federal Reserve Bank of New York**. New York. June 12, 2002. Telephone interview.
Jay Ritter	Cordell Professor of Finance, **University of Florida**. Gainesville, Florida. June 14, 2002. Telephone interview.
Jorge Guira	Lecturer in Corporate Finance, **University of Warwick**, Faculty of Law. Coventry. June 14, 2002. Face-to-face interview.
Peter Temple	Consultant, financial commentator and author of 'Hedge Funds: the Courtesans of Capitalism' (see References). London. June 14, 2002. Telephone interview.
Anonymous 18	**Goldman Sachs Investor Relations**. August 23, 2002. Email contact.
Bernt Gade	**Deutsche Bank Investor Relations**. Frankfurt. August 28, 2002. Email contact.

Henry Treitel	**Financial Services Authority**. London. September 2, 2002. Telephone interview plus follow-up email contacts.
Alastair Altham	Alternative Investment, **Morgan Stanley Dean Witter**. London. September 5, 2002. Telephone interview.
Martin Phipps	Hedge Fund Business of **Gartmore Investment Limited** (GIL). London. September 9, 2002. Telephone interview.
Christopher J. Airey	Chief Executive, **Old Mutual Securities Ltd**. London. October 10, 2002. Face-to-face interview. Email contact on August 27, 2002.
Kevin P. Walek	Concept Release CTAs and CPOs, **Commodity Futures Trading Commission**. Washington D.C. December 9, 2002. Telephone interview.
Jeff Duncan	Office of **Congressman Markey,** House Committee on Energy and Commerce, **US House of Representatives**, Washington D.C. December 10, 2002. Telephone interview.

THIRD PHASE: Financial Stability Forum

Charles Freeland	Deputy Secretary General, **Basel Committee on Banking Supervision**, Bank for International Settlements. Basel. January 7, 2003. Face-to-face interview.
Andrew Crockett	General Manager of the Bank for International Settlements and Chairman of the **Financial Stability Forum** until March 2003. Basel. January 8, 2003. Face-to-face interview.
Svein Andresen	Secretary General, **Financial Stability Forum** Working Group on Highly Leveraged Institutions. Basel. January 8, 2003. Face-to-face interview.
Allen Frankel	Head of Secretariat, **Committee on the Global Financial System** (CGFS). Basel. January 8, 2003. Face-to-face interview.
Kostas Tsatsaronis	Head of Financial Institutions and Infrastructure, **Bank for International Settlements**, and author of papers on hedge fund performance. Basel. January 8, 2003. Face-to-face interview.
Philip Wooldridge	Economist, Financial Markets, Monetary and Economic Department, **Bank for International Settlements**. Basel. January 8, 2003. Face-to-face interview.

Ric Battelino — Assistant Governor (Financial Markets) of the **Reserve Bank of Australia**. Australia's representative at the FSF Working Group on HLIs. Sydney. January 22, 2003. Telephone interview.

Charles Adams — **IMF**'s representative at the FSF Working Group on HLIs and Chairman of the Study Group on Market Dynamics. Mr Adams is now at the IMF Regional Office for Asia and the Pacific (OAP). Tokyo. January 22 and 27, 2003. Telephone interviews.

Giovanni Sabatini — Former Head of the Market Regulation Office of the **Commissione Nazionale per le Società e la Borsa** (Italy) and now Chief Executive Officer of Montetitoli Spa. Mr Sabatini was the Italian representative at the FSF Working Group on HLIs. Milan. February 4, 2003. Telephone interview.

Frédéric Visnovsky — Commission Bancaire, **Bank of France**. He was **Jean-Pierre Patat** alternate in the FSF working on HLIs and was also member of the Basel Committee Working Group on HLI. Mr Patat was the French representative at the FSF Working Group on HLIs. Paris. February 4, 2003. Telephone interview.

Jan W. Brockmeijer — Deputy Director, **De Nederlandsche Bank**, and former Chairman of the Transparency Group, Basel Committee on Banking Supervision. The Netherlands's representative at the FSF Working Group on HLIs. Amsterdam. February 5, 2003. Telephone interview.

Julia Leung — Executive Director, **Hong Kong Monetary Authority**. Ms Leung was very closely involved in the FSF Working Group on HLIs and attended many of its meetings. Hong Kong. February 21, 2003. Telephone interview.

GLOSSARY[85]

Absolute return: measure of *return* that do not take risk into account.
Active management: the pursuit of investment *returns* in excess of a specified *benchmark.*
Active portfolio strategy: a strategy that uses available information and forecasting techniques to seek better performance than a *buy and hold portfolio.*
Affiliate: two companies are affiliated when one owns substantial interest but less than a majority of the voting stock of the other company, or when two companies are both subsidiaries of a third company. An affiliated company is sometimes referred to as subsidiary.
Aftermarket: see *secondary market.*
Aggressive strategies: making a larger *short sale* or purchase than the trader would under normal circumstances.
Alternative Investments: investments in hedge funds. Hedge funds are said to pursue strategies that are uncommon relative to *mutual funds.*
Arbitrage: act of discerning and profiting from current price discrepancies that the market does not incorporate into prices. Several hedge fund strategies take their name from the application of arbitrage techniques in different contexts: risk arbitrage, convertible arbitrage, index arbitrage and so on (see Appendix 1).
Arbitrageur: an investor who performs *arbitrage.*
Ask: the price a seller is willing to accept for a security, also known as the offer price.
Assets: a firm's productive resources.
Balance sheet: a summary of a company's *assets, liabilities* and owners' *equity.*
Bandwagon effect: effect produced when investors, seeing an upward trend in prices, quickly enter *long positions* in an attempt to participate in the stocks' profitability. Typically, these bubbles are followed by even faster sell-offs once the prices begin to decline.
Bank run (bank panic): a series of unexpected cash withdrawals caused by a sudden decline in depositor confidence or fear that the bank will be closed by the chartering agency. Since the cash reserve a bank keeps on hand is only a small fraction of its deposits, a large number of withdrawals in a short period of time can deplete available cash and force the bank to close and possibly go out of business.
Best ask: the lowest quoted *ask*/offer price for a particular stock among all competing market makers.
Best bid: the highest quoted *bid* for a particular stock among all competing market makers
Bid: the price a potential buyer is willing to pay for a security.
Bid/ask spread: the amount that the ask price exceeds the bid
Black-Schole option pricing model: model for pricing call-options. Developed by Fischer Black and Myron Scholes in 1973.
Bond: *debt* issued for a period of more than one year. When an investor buys bonds, he or she is lending money. The seller of the bond agrees to repay the principal amount of the loan at a specified time. Interest-bearing bonds pay interest periodically.

[85] This glossary draws on the thesis' material as well as on two online financial information providers: Bloomberg at www.bloomberg.com and Investopedia at www.investopedia.com.

Bottom-up approach: management style that focuses on the analysis of individual stocks (e.g. arbitrage funds).

Broker/dealer: a person or firm in the business of buying and selling securities who operates as both broker and dealer, depending on the transaction. Technically, a broker is only an agent who executes orders on behalf of clients, whereas a dealer acts as a principal and trades for their own account. Because most brokerages act as both brokers and principals, the term broker-dealer is commonly used to describe them.

Bull market: market in which prices are in an upward trend.

Buy on margin: borrowing to buy additional *shares*, using the same shares as *collateral*.

Buy-and-hold strategy: a passive investment strategy with no active buying and selling of stocks from the time the portfolio is created until the end of the investment horizon.

Buyout: the purchase of a company or a controlling interest of a corporation's shares.

Call options: contracts that give its holder the right (but not the obligation) to purchase a specified number of *shares* of the underlying *stock* at a given price on or before the expiration date of the contract.

Capital Adequacy Ratio (CAR): a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.

Capital: money invested in a firm.

Carry Trade: an investment position involving the borrowing of funds in low-interest rates markets and the investing of those funds in *fixed income securities* in high-interest rates markets. In the run-up to the Asian crisis, investors fund themselves in yen or dollar at cheap rates and invested those funds in high-yielding East Asian *fixed-income* securities. This strategy was made possible by the presence of *currency pegs* in countries like Thailand, Indonesia and Malaysia.

Close a position: in the case of *equities*, eliminate an investment from one's *portfolio* by either selling a *long position* or covering a *short one*.

Collateral: *asset* that the borrower asks the lender to seize in the event of default.

Collusion: illegal practice whereby two or more *market makers* collectively attempt to influence and change the price of a *stock*.

Commercial banks: banks that offer deposit accounts and extend loans to individuals and business. They can be contrasted with investment banks, such as brokerage firms, which generally are involved in arranging for the sale of corporate or municipal *securities*.

Commercial lending: lending of money.

Commission: fee paid to a *broker* to execute a trade.

Committee on the Global Financial System (CGFS): G-10 central bank forum with the purpose of assisting the Governors in recognising, analysing and responding to threats to the stability of financial markets and the global financial system.

Commodity and exchange traded futures markets:

Commodity: food, metal or another fixed physical substance that investors buy or sell, usually via *futures contracts*.

Common stock: securities that represent *equity* ownership in a company. They let an investor vote on such matters as the election of directors. They also give the holder a share in a company's profits via dividend payments or the capital appreciation of the security.

Conglomerates: a firm engaged in two or more unrelated businesses. See Chapter 2: 41

Contracts for difference (CFDs): agreement to exchange at the closing of the contract the difference between the initial and the final price of an *equity* multiplied by the number of *equities* in the contract. Chapter 3: 30

Contrarian investing: doing the right opposite of what other investors do: i.e. ignoring market trends by buying securities that are out of favour with the other investors.

Counterparty credit risk: the risk that a counterparty to a transaction does not live up to their contractual obligations.

Counterparty: party on the other side of a trade or transaction.

Counterparty Risk Management Policy Group (CRMPG): group made up of 12 Western commercial banks and securities firms that got together to develop sound practices for risk management in banking and securities firms.

CPOs: Commodity Pool Operator. The person responsible for investing a *commodity* pool's

*asset*s in *commodity-futures* and *option*s positions.

CTAs: Commodity Trading Advisor. *Investment manager* that focuses on long and short trading in the *futures markets*. Sometimes referred to as Managed Futures.

Currency: money circulated within an economy (usually a national economy), which can than be traded against other national currencies.

Currency board: entity charged with maintaining the value of a local currency with respect to some other specified currency.

Currency depreciation: a decline in the value of one currency relative to another currency. Depreciation occurs when, because of a change in exchange rates, a unit of one currency buys fewer units of another currency.

Currency devaluation: a decrease in the spot price of a currency often initiated by a government announcement.

Currency manipulation: see *manipulation*.

Currency run: see *bank run*.

Custodian bank: a financial institution that has the legal responsibility for a customer's *securities*. This implies management as well as safekeeping.

Debt/equity ratio: Indicator of financial *leverage*. Compares *assets* provided by creditors to assets provided by shareholders. Determined by dividing long-term *debt* by common stockholder *equity*.

Debt: money borrowed.

Derivative instruments: contracts such as options and futures whose price is derived from the price of an underlying financial *asset* (stock, bond, currency, etc.)

Directional bets: funds do not take *offsetting positions*, e.g. they do not hedge, but invest on one side only of the market (the buying or the selling). They will profit if the market moves in the direction they betted on. Strategy used by macro-funds. Also called directional strategies.

Diversification: according to *Modern Portfolio Theory*, it means dividing investment funds among a variety of securities with different risk, reward, and correlation statistics so as to minimise risk.

Double play: simultaneously *selling short* the currency and the *equity market* (case of the Hong Kong market in August 1998).

Endowment funds: investment funds established for the support of institutions such as colleges, private schools, museums, hospitals, and foundations.

Equity index futures: a futures contract on a stock index, such as the S&P 500.

Equity market: see *stock market*.

Equity: ownership interest in a firm; also shorthand for *stock market investments*.

Expected return: in *Modern Portfolio Theory*, it is the average of a probability distribution of possible returns

Exposure: see *open positions*.

Fixed income instruments: *asset*s that pay a fixed dollar amount, such as *bonds* and *preferred stock*.

Fixed or pegged exchange rate: exchange rate whose value is pegged to another currency's value or to a unit of account.

Flight to quality: tendency of investors to move toward safer investments (often government bonds) during periods of high economic uncertainty.

Form 10-K: report required by the SEC each year. Provides a comprehensive overview of a company's state of business.

Form 10-Q: report required by the SEC each quarter. Provides a comprehensive overview of a company's state of business.

Forward contract: contract that obligates its parties to exchange given quantities of an asset at a pre-specified price on a certain future date. According to the asset, there are foreign currency forward contract, equity forward contract, and so on.

Forward market: market in which participants agree to trade some *commodity*, *security* or foreign *currency* at a fixed price for future delivery.

Futures commission merchant (FCM): a firm or person engaged in soliciting or accepting and handling orders for the purchase or sale of *futures contracts*, subject to the rules of a futures exchange. The FCM must be licensed by the CFTC.

Futures: contracts covering the sale of financial instruments or physical commodities for future delivery on a commodity exchange. Futures contracts are standardised according to the quality, quantity, and delivery time and location for each commodity.

General partner: a participant with unlimited liability for the obligations of a partnership.

Go long: to buy

Go short: to sell
Hedging: covering *open positions*.
Herding: following what other investors do instead of grounding one's investment choices on economic fundamentals.
Highly Leveraged Institutions (HLIs): hedge funds and other investors that pursue high-leverage strategies.
High-net-worth individuals: individuals with the capacity to invest at least $1 million in a single fund.
Initial public offering (IPO): a company's first sale of *stock* to the public.
Insider information: material information about a company that has not yet been made public. It is illegal for holders of this information to make trades based on it, however received.
Insider trading: trading by officers, directors, major stockholders, or others who hold private inside information allowing them to benefit from buying or selling *stock*. Illegal.
Institutional investor: a non-bank person or organisation that trades *securities* in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions. It includes insurance companies, depository institutions, pension funds, investment companies, mutual funds and endowment funds.
Insurance company: a company that offers insurance products/*policies*.
Insurance policy: a contract detailing an insurance policy and outlining what risks are insured, what insurance premiums are to be paid by the policyholder, what deductibles prevail, and all the details associated with a policy.
International Swaps and Derivatives Association (ISDA): the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (interest rate, currency, commodity and energy, credit and equity). ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents.
International organization of Securities Commission (IOSCO): associations of securities commissions from 102 countries with the aim of establishing standards and an effective surveillance of international securities transactions
Investment banks: financial intermediaries who perform a variety of services: underwriting, e.g. buying securities from a company and reselling it to investors; facilitating mergers and other corporate reorganisations; brokerage to both individual and institutional clients; and trading for their own accounts.
Investment companies: financial companies managing a *portfolio* of *stock*s, *bonds* or other *asset*s on behalf of a group of investors. Mainly mutual funds.
Investment manager: individual who manages a *portfolio* of investments. Also called portfolio manager or *money manager*.
Legal risk: the risk that a transaction cannot be consummated because of some legal barrier.
Leverage: use of debt to acquire *asset*s and in that way raise the expected *return* per unit of *capital* employed. See Chapter 2: 4 for a difference between on-balance-sheet/financial *leverage* and off-balance sheet/economic leverage.
Liability: a financial obligation, or the cash outlay that must be made at a specific time to satisfy the contractual terms of such an obligation.
Limited liability: limitation of loss to what has already been invested.
Limited partner: a partner who has *limited* legal *liability* for the obligations of the *partnership*.
Limited partnership (also private partnership or limited liability company): a *partnership* that includes one or more *limited partners*.
Liquidity risk: risk that arises from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimise losses.
Liquidity: a market is liquid when is characterised by the ability to buy and sell with relative ease.
Long positions: for equities, a long position occurs when an individual owns securities. The owner of 1,000 shares of stock is said to be 'long the stock'.
Manipulation: it occurs when a person or group of people illegally inflate or deflate the price of a *stock* (or any other *asset*s). People can deflate prices by placing hundreds of small orders at a significantly lower price than what

it has currently been trading. This gives investors the impression that there is something wrong with the company, so they sell, pushing the prices even lower. Illegal.

Margin: is the difference between the market value of a *stock* and the loan a *broker* makes.

Market benchmark: performance of a predetermined set of securities, used for comparison purposes. Examples are the *S&P 500*, Russell 3000 Index, World Index, etc.

Market capitalisation (of a fund): the debt and/or equity mix that finances a firm's assets.

Market index: market measure that consists of weighted values of the components making up certain list of companies. See also market *benchmark* and *S&P 500 composite index.*

Market integrity and dynamic (concern with): concerns with the impact of aggressive trading strategies and the accumulation of large and concentrated positions in small open economies and emerging markets.

Market maker: a broker-dealer willing to take the other side of the trade in securities trading. A market maker makes two-way markets, in the sense that, whatever the *counterparty* wants to do – to buy or to sell – the market maker quotes two-way prices, reflective of the *bid/ask spread* in the marketplace.

Market risk: risk that an *equity* investment loses value because of a general market drop. *Modern Portfolio Theory* calls it beta.

Mezzanine: the next stage of financing that follows *venture capital* financing.

Modern Portfolio theory: principals underlying the analysis and evaluation of rational portfolio choices based on risk-return trade-offs and efficient *diversification.*

Money manager: see *investment manager.*

Multidisciplinary Working Group on Enhanced Disclosure (MWGED): *ad hoc* working group set up in June of 1999 with the purpose of formulating recommendations for improving the public disclosure practices of financial intermediaries. Jointly sponsored by the Basel Committee on Banking Supervision; the Committee on the Global Financial System; the International Association of Insurance Supervisors; the International Association of Insurance Supervisors; and the International Organisation of Securities Commissions. Headquartered at the Bank for International Settlements in Basel.

Mutual fund: a security that gives small investors access to a well-diversified *portfolio* of *equities*, *bonds*, and other *securities*. Each shareholder participates in the gain or loss of the fund. Each mutual fund portfolio is invested to match the objective stated in the *prospectus*. Also the name of the *investment company* managing the portfolio.

NASD: National Association of Securities Dealers (NASD). A non-profit organization formed under the joint sponsorship of the investment bankers' conference and the SEC to comply with the Maloney Act, which provides for the regulation of the OTC market.

NASDAQ NMS securities: NASDAQ National Market System securities. Securities that have similar characteristics to those listed in organised exchanges, but are traded on the NASDAQ.

NASDAQ small-capitalisation market: a group of 2000 companies with relatively small capitalisation.

NASDAQ stock market: The first electronic stock market. It comprises two separate markets: the *NASDAQ National Market*, which trades large, active securities and the *NASDAQ Small-capitalisation (Smallcap) Market*, which trades emerging growth companies.

NASDAQ: National Association of Securities Dealers Automatic Quotation System. An electronic quotation system that provides price quotations to market participants about the more actively traded common *stocks* in the *OTC market.*

Negative feedback trading: investors buy after prices decline and sell after prices increase. See *contrarian investing.* They are said to push prices towards their equilibrium level.

Net interest income/revenues: proxy for revenues from *prime brokerage*

Net open interest: the sum of all positions of all sign in a market.

Offsetting positions: see *hedging* positions.

Open positions: a position exposed to *market risk*, e.g. a position not offset by another position of equal value and opposite sign.

Operational risk: the risk of human error or fraud or the risk that systems will fail to

adequately record, monitor, and accounts for transactions or positions

OTC Bulletin Board (OTCBB) market: an electronic trading service offered by the NASD, traditionally home to many small and micro cap companies (penny stocks). Very little regulated.

Overvalued stocks: stocks whose price is seen to high according to the company's *price-earnings ration*, expected earnings or financial condition.

Partnership: shared ownership among two or more individuals, some of whom have limited liability with respect to the obligations of the group.

Passive portfolio strategy: a strategy that relies on diversification to match the performance of some *market index*. It assumes that the marketplace will reflect all available information in the price of securities and, therefore, does not attempt to find mispriced securities.

Peg: see *fixed or pegged exchange rate.*

Pension fund: a fund set up to pay the pension benefits of a company's workers after retirement.

Performance evaluation: assessment of a manager's results. Usually, performance data are provided through three indicators: annual returns, *standard deviation* and *Sharpe ratio.*

Performance measurement: Calculation of the return a money manager realises over some time interval.

Portfolio: a collection of investments, real and/or financial.

Positive feedback trading: when investors buy after prices increase and sell after prices decline, thus pushing prices even further away from equilibrium level.

Potential future exposures: the exposure of a bank's or company's capital under different market scenarios.

Preferred stock: a security that shows ownership in a corporation and gives the holder a claim, prior to the claim of common stockholders, on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the *common stock* dividend. This stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt.

Price-earnings (P/E) ratio: current stock price divided by expected annual earnings per share.

Primary market: the market where a newly issued *security* is first offered. All subsequent trading of this *security* occurs in the *secondary market.*

Prime brokerage: special group of services that many brokerages give to special clients. It includes *securities lending*, leveraged trade executions, and cash management, among other things. Prime brokerage services are provided by most of the large brokers, such as Goldman Sachs and Morgan Stanley Dean Witter. Hedge funds started the prime brokerage option. Hedge funds place large trades and need special attention from brokerages.

Private banking: service that addresses one's entire financial situation. It includes everything from protecting and growing *assets* in the present, to planning retirement and passing wealth on to future generations.

Private placement: sale of a *security* directly to a limited number of investors. It is the antithesis of *public offering.*

Private Wealth Management: professional service combining financial/investment advice, accounting/tax services, and legal/estate planning for one fee.

Proprietary Trading or arbitrage desk: principal trading in which firm seeks direct gain rather than commission dollars. Proprietary trading is the bank's trading for its own account, that is, the bank's trading with the funds it collects from depositors and shareholders. In this business banks behave exactly like hedge funds: they can use *short selling* and *leverage*, *arbitrage* and *derivatives*, and can trade in any market.

Prospectus: formal written document to sell *securities* that describes the plan for a proposed business enterprise, or the facts concerning an existing one. Prospectuses are used by mutual funds to describe fund objectives, risks, and other essential information.

Public offering: in the case of *securities*, it means offering to the investment public, after compliance with registration requirements, usually by an investment banker or a syndicate made up of several investment bankers, at a price agreed upon between the issuer and the investment bankers. Antithesis of *private placement* (which is the modality used by hedge funds).

Put options: contracts that give the buyer the right to sell (or put) a fixed number of *shares* at a fixed price within a given period.
Qualified purchaser: see Chapter 2, page 10.
Regulated Investment Companies (RIC): A mutual fund or real estate investment trust that is eligible to pass the taxes on capital gains, dividends, or interest payments onto the clients or individual investors. This is done to help avoid 'double taxing' for investment distributions.
Repurchase agreement or repo: agreement in which one party (seller or dealer) sells a *security* to another party and agrees to repurchase it on a specified date for a specified price. The security serves as collateral against the obligation of the borrower and does not become the property of the lender. From the purchaser's (customer's) perspective, the deal is reported as a reverse repurchase agreement (or reverse repo).
Reputational risk: the risk arising from negative public opinion regarding an institution's products or activities.
Return: change in the value of a portfolio over an evaluation period.
Reverse repurchase agreement or reverse repo: a *repurchase agreement* from the customer's perspective. The customer provides a collateralised loan to the seller.
Risk lover: an investor willing to accept higher risk on the prospect of higher expected *returns*.
Risk management: the process of identifying and evaluating risks and selecting and managing techniques to adapt to risk exposures.
Risk: in the analysis of hedge fund performance, risk is intended as volatility of returns. For a more thorough analysis of risk see Chapter 5: 29.
Risk-adjusted return: return earned on an asset normalised (compounded) for the amount of risk associated with that asset. See *Sharpe ratio*.
Risk-averse: an investor who, when faced with two investments with the same *expected return* but different risks, prefers the one with the lower risk.
Riskless or risk-free asset: an asset whose future *return* is known today with certainty. It is commonly defined as short-term obligations of the US government.
S&P 500 Composite Index: index of 500 widely held common *stocks* that measure the general performance of the US market.
Secondary market: market in which securities are traded after they are initially offered in the *primary market*. All stock exchanges and the bond markets are secondary markets.
Securities lending: *margin* transaction by which banks lend *securities* to hedge funds in exchange for a *collateral*. Banks do not generally own the securities, but act as intermediaries between the owners/lenders of the securities and the borrowing hedge funds. See Chapter 3: 28-29.
Securities markets: *organised exchanges* plus *over-the-counter* markets in which *securities* are traded.
Securities services and fees: proxy for revenues from *prime brokerage*.
Securities: paper certificates or electronic records evidencing ownership of *equity* (*stocks*) or *debt* obligations (*bonds*).
Self-regulatory organisations (SRO): organisations that enforce fair, ethical, and efficient practices in the *securities* and *commodity futures* industries, including all national securities and commodities exchanges (and, in the US, the NASD).
Senior security: any *bond*, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness' (§ 18 (g) of the 1940 Act).
Shareholder: person or entity that owns *shares* or *equity* in a corporation
Shares: certificates or book entries representing ownership in a corporation or similar entity.
Sharpe ratio: measure of a portfolio's returns relative to the risk (defined as variability of returns) of an investment strategy. The Sharpe ratio gives what is called *risk-adjusted returns*. See Chapter 2: 30.
Short interest: aggregate short position in a share. In the US the short interest is publicly reported, but only for what concerns the cash equity market. This leaves out *OTC* markets, *repurchase agreements* and *contracts for difference*, which constitute the bulk of the short positions in a share.
Short position: a position in a portfolio is short when the investor has sold the asset short. See *short selling*.

Short selling: practice of selling a borrowed asset on the expectation that its price will decline by the time of repayment (Chapter 2: 4). E.g.: a trader borrows 100 shares of Company X on December 1 and immediately sells them at $10 per share. On January 1, the trader buys back 100 shares of Company X at $8 per share and gains $200.

Single-stock futures: contracts by which one party promises future delivery of an asset to the buyer at a prearranged price.

Spot markets: cash markets.

Standard deviation: measure of the variability of *returns*. In Modern Portfolio Theory it equals risk. See Chapter 2: 30.

Stock market: Market for trading *equities*. Also called *equity market*.

Stock risk: an *equity* investment can lose value because of a drop in the price of the selected *stocks*. *Modern Portfolio Theory* calls it alpha.

Stock: see *equity*.

Stockholder: see *shareholder*.

Stress test: simulative techniques used on *asset* and *liability portfolios* to determine their reactions to different financial stresses

Strike price: the stated price per *share* for which underlying *stock* may be purchased (for a call) or sold (for a put) by the *option* holder upon exercise of the *option* contract.

Superior returns: *returns* superior to the market (intended as *market benchmark* or *index*).

Swap: arrangement in which two entities lend to each other on different terms, e.g., in different *currencies* and/or at different interest rates, fixed or floating.

Systemic stability: concerns with the sudden liquidation of a highly leveraged fund and the knock-on or domino effects that this can have on the financial system

Top-down: investment style that begins with an assessment of the overall economic environment and makes a general *asset* allocation decision regarding various sectors of the financial markets and various industries (macro funds). Antithesis: bottom-up approach.

Trader: individual who takes positions in *securities* and their *derivatives* with the objective of making profits.

Trading: buying and selling *securities*.

Up-tick rule (rule 10a-1): SEC-imposed restrictions on when a short sale may be executed, intended to prevent investors from destabilising the price of a *stock* when the market price is falling. A short sale can be made only when either (1) the sale price of the particular stock is higher than the last trade price (referred to as a plus-tick or up-tick trade) or (2) if there is no change in the last trade price of the particular stock, the previous trade price must be higher than the trade price that preceded it (referred to as a zero plus-tick or up-tick). It only applies to *securities* registered on a national securities exchange (listed securities).

Value-at-risk (VAR): procedure for estimating the probability of *portfolio* losses. It says how much one can lose from holding a position over a set horizon (JP Morgan Risk Matrix: 2). This instrument was created by JP Morgan and penetrated the market in 1994 following the second BIS regulation on market risk.

Vendors or data providers: service firms specialised in providing information on hedge funds.

Venture capital: money made available for startup firms and small businesses with exceptional growth potential. Increasingly popular form of financing for new companies that cannot raise money through a debt issue because of a limited operating history. The downside for entrepreneurs is that venture capitalists usually receive a say in the major decisions of the company in addition to a portion of the equity.

Venture capital funds: funds that pool and manage money from investors seeking private equity stakes in small and medium-size enterprises with strong growth potential.

Yield spread: difference in yield between different *securities*, usually *securities* of different credit quality.

Yield: the percentage rate of *return* paid on a *stock* in the form of dividends or the effective rate of interest paid on a *bond* or note.

Appendix 1

Typology of Hedge Fund Strategies[86]

Convertible Arbitrage involves the purchase of a portfolio of convertible securities (usually convertible bonds) and the simultaneous short selling of the underlying common stock. According to market observers, and to the FSF, this was the most followed strategy in 2001 and 2002. There were rumours that this strategy could produce a bubble-like situation due to overcapacity.

Distressed Securities is the strategy used to buy equity, debt, or trade claims of companies in or facing financial difficulties (bankruptcy or reorganization). These claims are bought at deep discounts. Hedge funds can profit from these situations for two reasons: (1) the rest of the market does not understand the future/true value of the discounted securities; and (2) most institutional investors cannot hold downgraded securities (it is indeed this selling pressure from institutional investors, e.g. as mutual funds, that creates the deep discount).

Emerging Market funds invest in securities (equity or debt) issued by businesses and/or governments of countries with less developed economies, which have the potential for significant future growth. Investments are primarily long. This strategy is defined purely by geography: the manager may invest in any asset class (e.g. equities, bonds, currencies) and may construct his portfolio on any basis (e.g. arbitrage, macro).

Equity Hedge strategy consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Some managers maintain a substantial portion of assets within a hedged structure and commonly employ leverage. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions.

Equity Market Neutral strategy seeks to profit from price inefficiencies between related equity securities. It neutralizes exposure to market risk by combining long and short positions. One example of this strategy is to build portfolios made up of long positions in the strongest companies and to take corresponding short positions in those companies that display weakening results.

Equity Market Neutral: Statistical Arbitrage strategy employs quantitative analysis of technical factors to exploit price inefficiencies between related equity securities. Like in the previous strategy, portfolios are typically structured to be market, industry, sector, or dollar neutral.

[86] Sources: Hedge Fund Research (HFR); Van Hedge Fund Advisers (VHFA); Hedge Fund Association (HFA); and IMF 1998.

Equity Non-Hedge funds are predominately long equities, although they have the ability to hedge with short sales of stocks and/or stock index options. These funds are commonly known as "stock-pickers." Some funds employ leverage to enhance returns. The main distinction between equity non-hedge and equity hedge funds is that the former does not always hedge. In addition to equities, some funds may have limited assets invested in other types of securities.

Event-Driven funds are also known as "corporate life cycle" investing. It consists in investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks. Instruments include long and short common and preferred stocks, as well as debt securities and options. Leverage may be used. Fund managers may hedge against market risk by purchasing S&P put options or put option spreads.

Fixed Income: Arbitrage is a market neutral hedging strategy that seeks to profit from price inefficiencies between related fixed income securities, while neutralizing exposure to interest rate risk. Fixed Income Arbitrage is a generic description of a variety of strategies involving investment in fixed income instruments. Managers attempt to exploit relative mispricing between related sets of fixed income securities. The generic types of fixed income hedging trades include: yield-curve arbitrage, corporate versus Treasury yield spreads, municipal bond versus Treasury yield spreads and cash versus futures.

Fixed Income: Convertible Bond Funds are primarily long-only convertible bonds. Convertible bonds have both fixed income and equity characteristics. If the underlying common stock appreciates, the convertible bond's value should rise to reflect this increased value. This strategy offers downside protection because, if the underlying common stock declines, the convertible bond's value can decline only to the point where it behaves like a straight bond.

Fixed Income: Diversified Funds may invest in a variety of fixed income strategies. Areas of focus include municipal bonds, corporate bonds, and global fixed income securities.

Macro funds aim at profiting from changes in global economies, typically brought about by changes in government policy that affect interest rates, and currency, stock, and bond markets. They use leverage and derivatives to accentuate the impact of market moves. They might use hedging, but the leveraged directional investments tend to make the largest impact on performance.

Market Timing funds allocate assets among investments by switching into investments that appear to be beginning an uptrend, and switching out of investments that appear to be starting a downtrend. It primarily consists of switching between mutual funds and money markets. Technical trend-following indicators are used to determine the direction of a fund and identify buy and sell signals. In an up move "buy signal," money is transferred from a money market fund into a mutual fund in an attempt to capture a capital gain. In a down move "sell signal," the assets in the mutual fund are sold and moved back into the money market for safe keeping until

the next up move. The goal is to avoid being invested in mutual funds during a market decline.

Merger Arbitrage funds, sometimes called 'risk arbitrage' funds, consist in investing in event-driven situations, such as leveraged buy-outs, mergers and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and selling short the stock of the acquiring company.

Regulation D funds invest in Regulation D securities, sometimes referred to as 'structured discount convertibles'. The securities are privately offered to the investment manager by companies in need of timely financing. The terms of any particular deal are reflective of the negotiating strength of the issuing company. Once a deal is closed, there is a waiting period for the private share offering to be registered with the SEC. The manager can only convert into private shares and cannot trade them publicly during this period; therefore their investment is illiquid until it becomes registered. Managers will hedge with common stock until the registration becomes effective and then liquidate the position gradually.

Relative Value Arbitrage funds operate like equity market neutral funds, with the difference that they invest in a variety of instruments and not only equities (e.g. debt, options, futures). Managers may use mathematical, fundamental, or technical analysis to determine misvaluations. They use leverage and seek opportunities globally.

Sectoral funds focus on investment within specific sectors and/or industries (energy, health care/biotechnology, financial services, metals/mining, natural resources, utilities, real estate, technology, etc.). Investments can be long and short in various instruments, with funds either diversified across the entire sector or specializing within a sub-sector.

Short selling strategy involves the sale of a security not owned by the seller. It is a technique used to take advantage of an anticipated price decline. Apart from being one of the distinguishing features of hedge fund investing, short selling is also the name of a category of hedge funds specializing in short sales. To effect a short sale, the seller borrows securities from a third party in order to make delivery to the purchaser. The seller returns the borrowed securities to the lender by purchasing the securities in the open market. If the seller can buy that stock back at a lower price, he/she will gain all the difference between the selling and the buying price. If the price rises, however, a loss results.

Funds of Funds invest in a variety of hedge funds. This strategy consists of a diversified portfolio and is said to lower the risk of investing in a single fund. The fund of funds manager has discretion in choosing which strategies and managers to invest in. He/she may allocate money to different funds within a single strategy, or with different funds in multiple strategies. The minimum required investment in a fund of funds is usually lower than an investment in an individual hedge fund.

Appendix 2

Membership of the Financial Stability Forum

FINANCIAL STABILITY FORUM

National authorities G-7 (22) *	
Canada	o Department of Finance o Bank of Canada o Office of the Superintendent of Financial Institutions
France	o Ministry of the Economy o Commission des Operations de Bourse o Banque de France
Germany	o Ministry of Finance o Bundesanstalt für Finanzdienstleistungsaufsicht o Deutsche Bundesbank
Italy	o Ministry of the Economy and Finance o Banca d'Italia o CONSOB
Japan	o Ministry of Finance o Financial Services Agency o Bank of Japan
Netherlands	o De Nederlandsche Bank
United Kingdom	o Bank of England o Financial Services Authority o H M Treasury
United States	o Department of the Treasury; o Securities & Exchange Commission o Board of Governors of the Federal Reserve System
National authorities non G-7 (4)	
Australia	o Reserve Bank of Australia
Hong Kong	o SAR o Hong Kong Monetary Authority
Singapore	o Monetary Authority of Singapore
International Financial Institutions (6)	
IMF (2)	
World Bank (2)	
BIS	
OECD	
International Standard Setting, regulatory and Supervisory Groupings (7)	
Basel Committee on Banking Supervision (BCBS) (2)	
International Accounting Standards Board (IASB)	
International Association of Insurance Supervisors (IAIS)(2)	
International Organisation of Securities Commissions (IOSCO) (2)	
Committees of Central Bank Experts (2)	
Committee on Payment and Settlement	

System (CPSS)	
Committee on the Global Financial System (CGFS)	
European Central Bank	

FINANCIAL STABILITY FORUM WORKING GROUP ON HLIs

National authorities G-7 (9) *	
Canada	**David Brown** (IOSCO and Ontario Securities Commission)
France	**Jean-Pierre Patat** (Committee on the Global Financial System and Banque de France)
Germany	**Dietrich Jahn** Ministry of Finance
Italy	**Giovanni Sabatini** CONSOB
Japan	**Takashi Oyama** Bank of Japan
Netherlands	**Jan W. Brockmeijer** (Basel Committee on Banking Supervision and De Nederlandsche Bank)
United Kingdom	**Howard Davies (Chairman)** Financial Services Authority
United States	**Peter R. Fisher** (Multidisciplinary Working Group on Enhanced Public Disclosure and Federal Reserve Bank of New York) **Edwin M. Truman** Department of the Treasury
National authorities non G-7 (2)	
Australia	**Ric Battelino** Reserve Bank of Australia
Hong Kong	**Norman T. L. Chan** Hong Kong Monetary Authority, HK SAR
International Financial Institutions (1)	
IMF	**Charles Adams** IMF, Washington DC
Secretariat	**Svein Andresen** FSF Secretariat, Basel
	Verena Ross FSA, UK
	Adam Shapiro FSA, UK
	Andrew Sykes FSA, UK

* Note: Numbers in brackets show number of representatives per member or category of members

Note: All Internet sites were active at the time of the research. Hard copies of web documents and manuscripts are available from the author.

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